PROFITABLE INVESTING

FUNDAMENTALS OF THE SCIENCE OF INVESTING

BY

JOHN MOODY

PRESIDENT MOODY'S INVESTOR'S SERVICE

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THE OBJECT OF THIS BOOK —AND ITS WRITER

By B. C. FORBES

THE object of this book is to show you how to make safe and at the same time profitable investments.

Bankers, investors large and little, trustees of big estates and others gladly pay the author of this book nearly two million dollars a year for his services, and bond salesmen constantly quote, as the supreme authority on the merit of an investment, *Moody's Ratings.*

Just as gold is stamped to tell how many carats it contains, so investments are now stamped by John Moody. And his stamp is everywhere recognized as standard.

Go into a little bank in the remotest part of New Mexico or in the foothills of the Sierra Mountains or in rural New England and there you will find one or all of Moody's enormous volumes analyzing and appraising the four great classes of securities, industrial, railroad, public utility, government. Depositors consult Moody's before investing.

Multi-millionaires, heads of great financial institutions, trustees of huge estates and others handling

many investments now pay annually several thousand dollars each to have Moody pass upon their security holdings and keep them advised as to changes which should be made to guard against possible loss and to realize the largest possible income consistent with safety.

Smaller investors also turn to Moody for guidance. Thousands of them pay him $120 a year for a weekly investment letter and frequent letters on special subjects, supplemented by limited consultation privilege.

As an adviser on how to handle investment funds, John Moody has a larger following than any other man in America.

In this book Mr. Moody presents the cream of his investment knowledge and counsel.

In introducing him to its readers, *Forbes Magazine,* which published serially many of these chapters, described Mr. Moody as " The Man Who Puts Investments Through the ' Third Degree.' "

The late J. P. Morgan taught John Moody the first important lesson he learned in the field of finance. One day in 1890, after starting his apprenticeship with Spencer Trask & Company, the novice was standing at one of the windows when he noticed a veritable giant wandering from desk to desk. Every clerk seemed to shrivel up with fear when the big man approached. The clerk not having returned, the giant, who had very piercing eyes,

looked through the window where the messenger stood and asked, "What are you waiting for, sonny?"

The little fellow was instantly seized by the same fear and trembling. "A-a-a ch-check, for, for some bonds."

"What bonds?" snapped Mr. Morgan.

The giant's eyes seemed to bore holes right through him. He could neither think nor speak. Just then the clerk returned with the check.

Seizing it, Morgan turned to the messenger and asked, "Now, boy, tell me the amount of the check you are to receive."

"I-I don't know, I-I forget."

"Don't know? Forget?" roared Mr. Morgan. "What kind of a boy are you; what are you good for? Let me tell you something, young man. You will never be any good in business or anywhere else unless you learn to remember — to remember exact figures — *and facts.*" Saying which, he handed Moody the check and walked away.

Moody took to heart Morgan's injunction: "Learn to remember exact figures and facts." So successfully did he study figures and facts, *and their significance,* that by and by he began to be called upon by members of the firm to analyze financial reports and statements for them. He developed such a knack for compiling comprehensive yet easily understood statistical statements that he was given

scope to start organizing what was really the first complete statistical department in any Wall Street house. Before he was thirty he had become a department head.

His struggle to build up an efficient statistical department brought home to him that there was acute need for a work furnishing full information covering the finances and securities of corporations, especially industrial corporations, then becoming a very important factor investmentwise.

And so, after ten years' experience with Spencer Trask & Company, learning the ways of Wall Street, John Moody launched out as a purveyor of investment information. His first work was *Moody's Manual of Industrials.*

After early vicissitudes, especially during the panic of 1907, Mr. Moody set to work on what was destined to be a monumental series of invaluable guides for investors. The publication, in 1909, of *Moody's Analyses of Railroad Investments,* which rated thousands of bonds and stocks, brought a stream of letters from investors who wanted advice on all sorts of investment problems.

The stock market had long known tipsters who sought to wheedle money from speculators for tips on "sure things"; but no reputable individual or institution, he reasoned, was in existence to furnish legitimate investors with intelligent, dependable, unprejudiced information and counsel. Moody had

blazed a new trail with his investment manual and with his security ratings. He resolved to blaze another trail, a trail which he probably did not then foresee would bring him a unique reputation and riches.

On a nominal investment he has built up, without putting in another dollar of new capital, a business which he would not now sell for $3,000,000. From the start, Moody's Investors' Service has recorded substantial growth. To-day he occupies two floors in a large building in the financial district and employs as many as 180 co-workers, of whom over fifty trained experts do nothing but analyze and supervise the investment holdings of banks, trust companies, trustees, millionaires, and other investors. The fees for this service, which is in increasing demand year by year, run from $200 to thousands of dollars a year.

The phenomenal expansion in the call for Moody's services is conclusive testimony of the value they have proved to the tens of thousands making use of them.

In this volume John Moody gives you, in readily-digestible form, the ripe fruits of an experience unmatched by any other man in America.

May it enable you to profit and prosper.

B. C. Forbes.

Chapter I

THE MODERN INVESTMENT FIELD

THE scope of the American investment field has so vastly expanded in modern times that few people have any conception of its far-reaching extent. The changes in methods of production and distribution which have been going on in this country during the past fifty years have been so comprehensive that an actual revolution in the methods of modern industrial society has been taking place right before our eyes but with few of us realizing it.

Not to go into great detail, a picture might be drawn in outline of methods of wealth production as they existed a half-century ago as compared with the methods of to-day. In those earlier days, the outstanding characteristic of American business and producing activity was that practically all our work, of whatever nature, was being carried on by piecemeal and small-scale methods. Such a thing as the modern corporation, as we understand it, hardly existed then, except in the railroad field. Railroad corporations had been developing with the rapid railroad expansion which had begun during the fourth decade of the last century. But even rail-

road corporations, until about sixty years ago, were relatively small affairs and the railroad mileage of the country was divided up in ownership among several thousand organizations.

In the field of industrial activities, corporations were in their infancy. The steel and iron trade was just beginning to make itself known and, aside from one or two instances, iron production and distribution were being carried on by individuals or small firms. It is true the petroleum industry was then developing under the corporate form, but it was distinctly a pioneer.

In public utility activities, such as the supplying of light, heat, water or power and the operation of street railways, anything resembling the corporation of to-day was almost unknown. Generally the gas lighting plant of a community was owned by the municipality, by some few individuals in the municipality, or by a very small company whose interests were purely local. Water companies were generally owned and operated by municipalities, and horsecar lines, where they existed, were controlled and usually operated by purely local interests. In the majority of cases such ownerships were largely in the hands of the operators, and no outside investing public was to any extent interested in them.

When it came to the matter of public debts, considerable financing was done among individual investors, but in most cases such financing was quite

generally local. Thus, aside from the wider public interest in Governmental obligations growing out of the Civil War, the investing public was extremely limited in number and did not represent any large amount of capital. Only in the single field of railroad financing was there any outstanding distribution of bonds and stocks among individual investors.

It is indeed a far cry from those days to these. The long road which has been traveled since 1875 is full of startling developments and appeals greatly to the imagination of any thoughtful man. For the growth of the American investment field is coincident with the growth of the country from a small, comparatively undeveloped debtor nation to the point where we have become the largest, and practically the only great creditor nation in the world, with financial and other resources perhaps exceeding the real wealth of the whole world a half-century ago.

A glance at the industrial history of the past fifty years will bring to the front many interesting facts. Since 1875 we have witnessed the discovery and development of many marvelous inventions which have entirely changed the face of industrial civilization. In 1875 the telephone had just been invented, the electric light had in no sense been perfected and was in an experimental stage, electric power for transportation and for a thousand other purposes was then unheard of. Steel rails were just being

generally adopted by the railroads; but it was far from the time when steel construction would be used for building purposes of any kind. Petroleum had come somewhat to the front but only for lighting purposes. The automobile had not yet been invented. No serious thought had been given to such a thing as the aeroplane and any one who suggested the possibilities of wireless telegraphy or of the radio would have been looked upon as a lunatic. The moving picture, which is responsible for one of the biggest industries in this country to-day, was not thought of for twenty-five years after that time.

Coincident with the development of these outstanding inventions, thousands of minor inventions, affecting every producing and distributing activity in the country, have been perfected and come into use. Consequently the world we live in to-day is further removed, in its material aspects, from the world of 1875 than was the world of 1875 from the world of several centuries earlier than that.

In view of this marvelous evolution which has taken place in human affairs in half a century, it is natural enough that banking and finance should have gone through an equally extensive series of changes. Thus when we speak of the financial world of 1925 we mean something immensely greater than and distinctly different from that of fifty years ago.

It will be apparent to any thoughtful person that the vast developments in industry, the expansion from small units of activity to great units, must have involved the development and perfection of some sort of intricate but gigantic machinery for the carrying on of material civilization as it exists today. For, first and foremost, the world's great workshop which has been developing has necessarily required as its chief essential the capital and resources for carrying on its various functions. As in the case of the individual business, if operated on any important scale at all, its capital or credit is its corner stone. Without capital or without credit enabling it to secure necessary capital, it could not function at all.

Inevitably, therefore, a developing material civilization such as we find in the United States has been accompanied by an equally remarkable expansion of the field of investment of capital. There is no one source for capital and never has been. Capital must be secured for a given proposition from many sources, provided that any substantial amount of it is needed. In the days of Washington production was carried on in such a small retail way that often one or a few men could supply the needed capital for any particular enterprise. Later, a small group of men or a limited number of citizens of a community could generally chip in to supply the funds for what was then a substantial enterprise.

But with the modern development of industry, the individual capitalist is only a minor factor. The billions of capital which are necessary for carrying on large-scale production and distribution must be drawn in limited amounts from many thousands or hundreds of thousands of the individual citizens of the country.

It is only because, through a long series of experimental years and through the trying out of various methods, a comprehensive machinery has been developed and more or less perfected for the correlation of capital, that modern industrial society is at all possible.

Consequently, we find that this country has become, more and more, a nation of investors. Time was when the investor class, so-called, was supposed to be limited to a few millionaires, a few thousand retired business men and a few widows or orphans who had inherited money. But in these days the investor class in the United States is in no way limited in its characteristics and is made up of every type of institution or individual, big and little. More than any other group, the typical business men of this country are the investors of America. Practically anybody who has accumulated savings who has a surplus of any kind in his business or outside of his business, who has inherited wealth or has wealth which he is not personally making use of, is a member of this great class of investors.

The investor class in the United States has grown by leaps and bounds since the World War. It is known that approximately twenty million people invested in war bonds and a very large percentage of these were people who, prior to that time, had never invested money in anything and had never seen a bond or a stock. Investing in war securities was their first lesson in placing funds in something outside their own personal activities or in savings banks. This experience not only opened the eyes of millions to the meaning of the word "investment," but it introduced on a large scale the thought of saving money systematically and putting it to work to earn an income.

Naturally, as a factor in this great investment era which has grown up for the correlation of capital, there has developed a comprehensive mechanism for the distribution, throughout the country, of the security obligations of corporations, governments, and municipalities. The old idea of a banker was an individual who dealt only with a limited number of depositors or business men, paid interest on deposits, and loaned money on good security for the accommodation of business men or others. But nowadays we have a new departure in the banking field. The last quarter century has seen the advent of the investment banker whose primary business is not to receive deposits or to loan money, but to distribute, through modern selling methods, the

many thousands of security issues, both bonds and stocks, which are created as wealth production goes on, by the corporations of the country and by the governments and municipalities. This investment banking business has become such an important factor in our modern life that the machinery of production could not possibly go on without it.

Of course, it will be realized that in this modern development of large-scale production and country-wide financing, much of the work done has been experimental and many mistakes of method and other evils have developed with its growth. It has not been plain sailing for the industrial world to evolve from its old, simple, small-scale and one-man methods to the modern conditions which we know. As in everything else, human limitations have always been present. Mistakes of judgment have been characteristic of the period of development and numerous methods of financing have at different times been tried out and found wanting. New conditions demand new methods, and consequently there are no absolutely perfect or permanent rules for financing corporate or other undertakings. One of the characteristics of the modern period of corporate development has been the extent and the disastrous outcome of speculative ventures of one sort or another. As the country has grown and expanded in wealth and productive power, speculative movements have often run riot in the business

and corporate field. This has been a conspicuous fact of modern times.

In human society it is impossible to expect development or progress without the venturesome or speculative nature of human beings asserting itself. Over-optimism, over-confidence, over-vision are more characteristic of Americans, perhaps, than they are of any other people in the world. The typical American is venturesome and always ready to take chances. Thus, America has been a fruitful field for generations for the promoter of visionary schemes, for the seller of unsound propositions and for the unscrupulous peddler of more or less worthless securities. This is natural enough, for it would be a strange world if all men were so shrewd and so cautious that they could never be duped or fooled.

With the enormous expansion which has taken place in the investment field and in industrial enterprise generally, the amount of the wealth which is every year mistakenly invested by the people of this country in speculative, or worse than speculative securities, reaches an alarming total. It is currently estimated that at least half a billion dollars per annum is lost by the people of the United States through the promotion of worthless securities by unscrupulous men. It is my personal opinion that this estimate is extremely low and if we include the vast amounts which are lost by people who are not necessarily cheated but

whose judgment is unsound or who are misled through ignorance, we would probably find that the annual loss might aggregate at least a billion dollars. This amount is a staggering one. It is even more than the American Congress has probably wasted in its most extravagant years.

In the chapters that are to follow it is my purpose to try to draw the line of demarcation between true investment and speculation; to explain, in simple but complete detail, the sound principles for investing money; to visualize the different types of security issues; to indicate the kinds of securities different types of people should wisely select. In short, to furnish a complete but non-technical textbook on the science of investing.

Chapter II

INVESTMENT VERSUS SPECULATION

BOTH the word "investment" and the word "speculation" are much misused terms. There are perhaps no two words in the English language which are less clearly defined or understood. This fact is not only true in a general sense, but it is particularly true in what we might term a "Wall Street" sense. There are many out-and-out speculators who call themselves investors and who honestly think they are investors. On the other hand, we constantly meet people who are really trying to follow sound investment methods and yet consider themselves speculators.

The main reason why there is so much confusion regarding the meaning of these terms, especially in connection with the security markets, is that investment and speculation so lap over each other and are so closely related that it is extremely difficult to draw any distinct line of demarcation between them. The vast majority of security investments carry some element of a speculative character; whereas a respectable percentage of securities which are inherently in a speculative class always embrace

elements of stability and genuineness which give them an investment tinge.

Strictly speaking, a pure investment is something which carries no substantial risk whatever, either as to the security of the principal sum or the certainty of the income return. Perhaps there are no securities in existence which carry no speculative element whatever. For example, the premier securities of the world at the present time are generally understood to be the obligations of the United States Government. The United States enjoys the highest credit of any large nation in the world; its resources and the wealth of its people are greater than those of any other nation; its debts, while heavy, are relatively small as compared with the debts of other large nations. The standards of living and general well-being of its population are on a higher plane than those of any other large nation.

It is, therefore, almost inconceivable that anything could happen to United States Government obligations to place them in a speculative class. There is a general saying that if Liberty bonds are not good, then nothing is good. And there is much truth in this.

At the same time, even United States Government bonds carry a speculative element. There is no absolute assurance that the civilization in which we live will be maintained indefinitely at its present

status. There is no complete certainty that the United States Government will never be subject to revolutionary changes or to other developments which would put its future in doubt. Of course, the danger of such events is extremely remote, but nevertheless there is always the possibility of profound changes taking place in the structure of society as time goes on.

Unreflecting people as a mass take the world for granted as it is. And the average man probably does not stop to reflect that our modern industrial civilization, such as we all know, is a development of a very short period. The capitalistic system under which we live appears to be, on the surface, as permanent as human nature itself, but this is far from true. The men of one hundred years ago never dreamed of the type of civilization in which we live to-day, and it is certainly entirely impossible for us to visualize accurately the civilization which may exist one hundred years from now. A dozen years ago when French and German obligations were quoted on a 3 per cent. basis, no man would have been looked upon as in his right senses who then said that within a dozen years the entire German Government debt would be practically worthless, and nations like France would have to borrow money on an 8 per cent. basis. In 1912 the United States Government could have borrowed billions of dollars on a $2\frac{1}{2}$ per cent. basis, but by 1920 it was

necessary for this government to pay from 5 to 6 per cent. for its borrowings, and its great war loans for a very long period were quoted at a heavy discount.

To take another illustration. Twenty-five years ago the highest grade American railroad and municipal bonds were generally quoted on a 3 to a 3½ per cent. basis. In the year 1897 the New York Central Railroad refunded its old mortgages on a 3½ per cent. basis through the issue of a hundred-year bond at 3½ per cent. This bond was easily sold at a premium, and at one time was quoted at 110. The almost universal belief at that time was that interest rates through the twentieth century would continuously decline and that within twenty years it would be impossible to find investments of this high-grade character which would yield more than 2½ to 3 per cent. In 1897, when British Consols were quoted on a 2 per cent. basis it was freely predicted by British economists and banking experts that the time would shortly come when Great Britain would be able to finance its government debts at an even lower rate.

I bring out these illustrations simply to emphasize the fact that even the best investment has its speculative tinge. As the old saying is, there is nothing absolutely certain in this world except death and taxes.

It will, therefore, be seen that when we speak of

pure investments, we do not mean something that is absolutely perfect, but rather something that is relatively sound. There are various degrees of security and the best investments are those which most closely approach the ideal of security.

To take the other extreme — that of so-called speculation. There are all kinds of speculative propositions in the security field, extending all the way from the pure gamble or wild guess to the type of proposition which carries some elements of genuineness, but which elements are so heavily overbalanced by uncertainties and general unsoundness that the security is not entitled to be classed as anything but a risky speculation.

As a matter of fact, the poorest speculations of all are the types of issues which are not even entitled to be called speculations. A speculation is something in which there is supposed to be an element of chance for success. This element may be a small thing, but it is supposed to be there nevertheless. But there are masses of securities sold in this country and traded in every day which are so definitely worthless and are so entirely sure to result in complete loss to the purchaser that he who buys them has not even the wildest gambler's chance.

The man who buys a fraudulent mining or oil stock which perhaps has nothing back of it except a hole in the ground is not speculating; he is throwing his money away. The thousands of people who

bought German marks after it became a certainty that Germany could never stabilize her currency without a complete revolution of her banking system were not speculating or gambling; they were throwing their money away. The speculative period in German marks had ended for all time when the Allies went into the Ruhr. Before that, there was perhaps a gambler's chance in buying marks, but not after that. The people who bought Russian rubles after the second revolution were also throwing their money away.

If we look over the entire security field of America we will find that investments and speculations could be subdivided, in the matter of degree, into hundreds of different classes. Starting with the highest and most secure type of investment known (United States bonds), we can follow the divisions down to some arbitrary line of demarcation where the investment groups, so-called, practically end with securities in which real investment elements slightly overbalance speculative elements. And from then on down through the various degrees of speculative propositions, from the so-called speculative-investment or good speculation until we reach the low grade or almost worthless speculative scheme.

No outstanding or clear-cut line of demarcation can be determined between that large group of securities which can be fairly classed as investments and that even larger group which we would define

as speculations. One great group tends to blend into the other. There is always a sort of twilight zone between them.

Before going into the question of specific investment selection as compared with speculative selection, one important underlying fact, which has great bearing on the entire problem of investing money in security issues, should be thoroughly emphasized. The problem of investing money wisely and safely cannot be solved for anybody by simply concentrating on the specific merits or demerits of particular securities themselves. There is one great underlying aspect of the whole problem which must first be given proper consideration. That is the problem of studying and analyzing the broad fundamentals which at any given time underlie all business, financial, and industrial activity. Enough has been said in the foregoing pages to indicate that even the best securities are not always desirable things to buy at particular times.

Let us return for a moment to the illustration of long-term railroad bonds, such as the New York Central 3½s, issued in 1897. While at that time, if one considered only the intrinsic security and other factors of strength back of this issue, it could be easily demonstrated that it should be classed as among the highest grade investments, yet, as subsequent events proved, this was by no means so. If we examine the record we will find that within a

few years after 1897 the New York Central 3½s began a steady decline which did not culminate until 1921, when the bonds were quoted below 63 cents on the dollar.

Consequently, a study of underlying elements and fundamental influences of a broad, general nature is just as necessary to determine the wisdom of investing money as is the study of the specific factors themselves. While a temporary speculative investment or a pure speculation may be judged intelligently, to a large degree, by confining one's attention primarily to the facts affecting the enterprise itself, this is not nearly so true when we turn to the field of genuine investments.

For many years I have expressed the view that in the long run more money is probably lost by people who attempt to invest their money conservatively and sanely, but ignorantly, than is lost by those who enter into frank speculations. The loss of a high percentage of investment capital is due to the fact that proper consideration is not given to the broad, fundamental influences which are often so far-reaching and so permanent in their effects.

Any one who wishes to become a successful investor must first of all familiarize himself with broad economic conditions and tendencies as they exist in our modern industrial society. He must know something about modern finance and must understand

the significance of general trends and of structural changes which are constantly at work everywhere.

The man who a dozen years ago gave thought to the fact that slowly but surely the world's interest rate was rising and the average cost of living and cost of production increasing, need not have been caught with investments in enterprises like street railways and other franchise corporations whose revenue is fixed or limited by law but whose producing or operating costs must necessarily increase with the trend of the times. Such a man would not have bought or held Interborough Rapid Transit 5s which were then selling above 95.

Many people cherish the notion that investment in partially developed activities or relatively new undertakings is always more speculative than investment in old and tried and seasoned securities. But this theory does not hold in many cases. As a matter of fact, the old and seasoned security, unless purchased at the proper level and at the proper time (assuming, of course, that it is not merely a short term obligation) often proves to be the poorest thing to buy.

Men like John D. Rockefeller, Andrew Carnegie, and Henry Ford are constantly mentioned as persons who in their early days were venturesome dreamers and daring speculators in their particular fields. Of course, these men did many speculative

things, took chances, and had many narrow escapes from disaster. But the real thing that gave them success, as compared with thousands of others of equal ability, courage and general intelligence, was their special understanding of certain fundamental facts which were in the making in their early days. John D. Rockefeller had imagination enough to recognize the far-reaching possibilities in the development of the petroleum industry. The question as to whether he could currently make money in a small oil-producing concern and compete with many others was not the big idea with him. The secret of his success was his recognition of the revolution which would be wrought in modern society by the newly discovered uses for petroleum. Herein was his investment sense demonstrated.

Andrew Carnegie had imagination enough to foresee the inevitable revolution which would be brought about by the development of Bessemer steel. Carnegie may have been a great speculator when he capitalized his companies and sold them for a fabulous sum to the Morgan syndicate, but in his early days he was a shrewd investor.

Henry Ford many years ago foresaw the revolution which would inevitably be brought about by the development of the automobile. He had imagination enough to understand that the most far-reaching change would be the adoption of the motor car by the millions rather than by the few. He

therefore chose to serve the millions and has consequently become one of the most successful business men in the world.

The point to be emphasized in these illustrations is that these men gave full thought to the big underlying facts which were developing before their eyes, but which the mass of mankind did not see at all.

Finally, to draw a distinction between intelligent investment and speculation, it should again be emphasized that successful investing involves far more attention to the meaning of fundamental trends and general economic conditions than does the ordinary speculation. The person who intentionally places his capital to work for income and genuine stability of principal should be more concerned with possible changes in general conditions and with the broad underlying currents of trade and finance than the man who frankly goes into a speculative proposition for the purpose of quickly increasing his capital. The speculator is almost invariably one who is looking for quick profits. Ordinarily he does not expect or intend to keep his capital in any given thing for any great period of time. Underlying influences affect his position, of course, but if his speculation is a wise one, its strength may be so great as to offset general adverse influences should such come along.

The investor, theoretically at least, is placing his

capital to work more or less permanently. He does not expect to change his holdings of securities with every month or every year. If he buys bonds or stocks for investment at a certain yield, his intention is to hold such bonds and stocks. He may change frequently to other issues without becoming a frank speculator. But if, unexpectedly, his investment promptly shows him a large profit and he sells out, he has simply cashed in on a speculative development which he did not foresee.

This situation, of course, exists in thousands of cases and this is why there is no clear-cut distinction between the great investor group and the great speculator group. Many a man is both an investor and speculator at the same time. Many are investors for a period and then become speculators for a period. In fact, every investor who does not give proper consideration to the broad, underlying fundamentals is in danger of unknowingly becoming a speculator at any time. He may buy what he thinks is a high-grade investment, but the time may quickly come when to his surprise he finds himself the holder of a speculation.

To sum up, the investor pure and simple is the person who, when placing his capital at work, gives as full thought and consideration to general and fundamental factors underlying our modern civilization as he does to the specific questions of security, management, past records, financial stability, and

earning power of the proposition itself. He may often be in error and exercise unsound judgment. He may be misled or misinformed and his knowledge may be superficial. If he does not look at the whole picture and acts only on a section of it, he will, sooner or later, come to grief.

Chapter III

SELECTION OF INVESTMENTS

HAVING discussed at some length in the previous chapter the necessity of giving due weight to what are known as fundamental influences in the matter of security investments, pointing out the broad distinctions between investment and speculation, we are now ready to go ahead with a discussion of proper methods for the selection of investments for the typical investor.

While there are thousands of different types of corporate undertakings in existence, they can be broadly classified into a few great groups. The pioneer type of large corporation in this country, and the largest group, is the steam railroad. Thus railroad securities are still classed as the most outstanding single group of interest to investors.

Next we have what has come to be known in modern days as the public utility group. This group is more diversified in its characteristics than the railroad group. Public utilities, as generally classified in this country, embrace all types of franchise corporations such as gas, electric light and power, water power, electric traction, and telephone and telegraph companies. This group has steadily

grown in size and importance, and in these days has reached a position of permanence and stability which was not dreamed of a generation ago.

It is the general custom to classify all corporate undertakings which are not railroads or public utilities, as industrials, and thus we have what is known as the industrial group of securities. But this is a very broad definition and the so-called industrial group can be divided into many parts. For example, generally classed as industrials are mining and oil companies which might be considered in a group by themselves. Steel and iron, copper and other great producers and perfecters of raw materials might be placed in a group by themselves. Finished manufactures of a thousand different types could be classed as a distinctive industrial group. Then there are such business activities as the moving picture industry, the chain store industry, the automobile industry, and other outstanding enterprises which might well be considered as distinctive in themselves. So that, as a matter of fact, in the so-called industrial field alone we have many groups of securities which are quite as independent of each other as steam railroads and public utilities. It is really absurd to classify coal mining companies and moving picture companies as being in the same group.

Beyond these groups in the modern investment field, and especially within recent years, the invest-

ment obligations known as public securities have steadily become a group of more and more importance. Not only the obligations of cities and towns but the funded debts of nations have become a factor of distinct interest and importance in the American security markets. This situation has largely grown out of the changes brought about by the Great War. To-day the typical investor who is confronted with the problem of selecting his investments is not confined to the selection of corporate securities alone, but has equal opportunities in the selection of public securities, both those at home and those which emanate from abroad.

It will, therefore, be seen that the investor who is interested in placing his capital at work, through the purchase of bonds or stocks, has practically an unlimited field to choose from. If he has any substantial capital for investment he can set it to work in dozens of types of enterprise and industry; he can diversify it into all parts of the country, and, if he wishes, into all parts of the world. He can, if he desires, place a portion of his funds in New York, another portion in California, another portion in Buenos Aires, another in France or Belgium, another in Scandinavia, and some in Japan, Austria, Italy, Australia, and the islands of the sea. There is practically no important spot on the face of the earth where an American cannot set his capital more or less safely to work.

The diversification of investment capital is one of the important rules which every investor should adopt. But true diversification implies a great deal more than merely investing money in different parts of the country or different parts of the world. Geographical diversification is a sound policy but it is by no means complete diversification.

Aside from the matter of geographical location, diversification of investments involves such questions as the character of the industry or obligation, its size, its relationship to various influences and other fine but equally important distinctions. A man might decide to invest 10 per cent. of his capital in California. There are probably a hundred ways in which his money could be invested in California. He might decide to diversify it by dividing it up between five hydroelectric companies in that state. But this would not be complete diversification, because his whole fund would be tied to one industry and even though there might be much distinction between one company and another, yet they all respond to the same general influences and in this sense his eggs would all be in one basket. He would get more genuine diversification by placing a portion of his funds in an electric power company, a portion in a manufacturing company, a portion in a chain store or distributing company, and perhaps a portion in a shipping or railroad company.

Diversification in the true sense involves a classification of the different types of enterprise which are more or less unrelated to each other. A man might invest in the Norfolk & Western Railroad. This railroad is primarily dependent for its prosperity, not on passenger traffic and not necessarily on local business conditions in its territory, but on conditions in the soft coal trade. Consequently, a man might accomplish some diversification if he placed a portion of his funds in Virginia or West Virginia, in some manufacturing enterprise, even though it were located on the lines of the Norfolk & Western Railroad. If he were confining his investments to railroad obligations but wished broad diversification, he might wisely invest a portion of his money in railroad securities of the type of the New York Central, which reflects commercial or industrial activity. He could invest a portion in an anthracite coal property like the Reading or the Lackawanna railroads; a portion in a Southern property which is dependent on conditions in the cotton industry, or in the Southern States generally; a portion in some transcontinental line like the Atchison or Union Pacific; a portion in some Northwestern road which reflects crop conditions in that territory; and a portion, let us say, in some cross-country system such as the Illinois Central.

In the field of public utilities, proper diversification would involve not merely the selection of the

different types of utilities, such as gas, electric light, traction, power or telephones, but due consideration should be given to the location of such companies, whether they are identified with cities of large population and diversified industries or whether they are in centers which might be dependent on crop conditions, on mining conditions, or on single industries. For example, the prosperity of a city like Detroit is largely dependent on conditions in the motor industry; a city like Butte, Montana, is dependent largely on conditions in the copper industry; a city like Providence, Rhode Island, is to a considerable extent dependent on conditions in the textile industry. Problems of diversification must take into account all such facts as these. While fundamental business influences, in a broad sense, affect the country as a whole, yet there are often times when one section of the country may be prosperous and another not so. Witness conditions in the Southern states during the years 1923 and 1924 as compared with conditions in the Northwestern grain-growing states.

In the many groups broadly classed as industrials, the opportunities for diversification are practically unlimited. An investor whose capital is placed partly in the chain store industry, partly in steel or iron, partly in equipment construction, partly in some specific but standard type of manufacture, partly in petroleum production or distribu-

tion, and partly in motor construction, may enjoy very distinct diversification.

The opportunities for diversifying investments in the field of government and municipal securities are fully as great as in other fields. Such diversification involves not only the questions of geographical location, but many others. In the American field alone, one can invest his money in every state of the Union. If he goes across the border, he can invest his money in Canadian obligations, both governmental and provincial, and he will find broad differences in character, stability, and security. If he goes further into the foreign field and seeks foreign investments he has, not only the old countries of Europe to choose from, but also South America and Asia. He can select many types, both high grade and low; he can select short-term or long-term obligations; he can guard against the dangers of putting his money into issues which respond or are affected by the same dangers, and thus get an extremely broad diversification.

Continued emphasis should be placed on the great importance of intelligent investigation and care in ascertaining all of the facts bearing on any particular investment before the security is actually bought. The great weakness of the typical American investor is his tendency to take things on faith and his willingness to accept superficial advice or to act purely on impulse. Everybody should investigate before investing.

It is a pathetic fact that many a business man will spend thirty years in building up a fortune from his own business, and then, when he cashes in, will spend thirty days or less in investing it in securities concerning which he really knows absolutely nothing. I could mention the name of a widely known and successful business man in New York who recently went into bankruptcy because he had persisted in buying bonds and stocks without intelligent investigation, during the very time when there was open to firms of his trade the opportunity of a century to make unusual and fabulous profits in his own business. His wise investment was his business. He had grown up in it, had learned its every detail, and it had become a part of his life. He could not be easily fooled in his own business, but was promptly made a fool of when he attempted to put his money into what he thought were investment bargains.

The problem of diversifying investment capital, however, involves considerably more than the matters which I have been discussing. Not only are there numerous types of industry and unlimited types of governmental obligations for the investor to choose from, but the characteristics of security issues themselves vary in many ways. The two great types of investment securities are bonds and stocks. Technically there is a very definite distinction between a bond and a stock as an investment. A man who invests money in a bond is always a loaner of

money, but one who invests in a stock is not a loaner of money. The stockholder is always a partner in the enterprise, whatever it may be. As a partner he assumes his share of the business risk which the partner or owner of an enterprise naturally must assume. But if he is a bondholder, he always has, in some form or another, a prior claim as against the stockholder of the same corporation. This prior claim, of course, may be qualified or limited in various ways. It may be a mortgage or claim on only a portion of the property; or it may not be a mortgage at all, but simply a promise to pay.

In the same way, the stockholder who is a partner may have only a qualified or limited interest in the business. Should he be a preferred stockholder he will, in some cases, have a prior claim over common stockholders as to assets and certain specified dividends; in others, perhaps only a prior claim as to dividends but not as to assets.

It will be recognized, therefore, that full consideration should be given to the type of security obligation to be purchased. The investor who has any substantial amount of funds to invest should not necessarily limit his selections to bond obligations alone. It is a false notion to assume that if a security is in the form of a bond it is necessarily better than a stock. Very often it is, but there are countless cases where it can be easily demonstrated that certain stock investments are far more secure

and far more worthy of favorable investment consideration than are many bond issues.

But the question of diversifying investments among types of securities carries one much further than the problem of investing in bonds versus stocks. One must consider the characteristics and types of bond or mortgage obligations. These are almost without number. In practically every field of industrial and commercial activity, one will find different types of bond obligations; issues secured by first, second, third, or fourth mortgages; issues secured by what are known as consolidated or general mortgages; issues secured by the deposit of collateral which is sometimes in the form of other bonds or of stocks, or of both stocks and bonds; issues which are not mortgages at all but are simply promises to pay; issues which get their main strength through the formal guarantee of some other corporation; issues which carry unusual features such as convertible privileges; and finally, issues which run many years before maturity and issues which mature in the immediate future.

In the field of stocks, there are also many variations. We have in the preferred stock group alone various types of issues, some carrying fixed, cumulative dividends, some non-cumulative dividends, and some with special protection in the shape of retirement funds or sinking funds. A large number of preferred stock issues, especially in the industrial field, are subject to redemption at certain premiums.

Preferred stock issues are also often convertible, at the option of the holder, into some other security, such as a common stock or possibly a bond.

Finally, it will be realized that in the problem of investment selection questions of yield and price are important. In the pure investment field, prices and yields are more or less directly dependent on general business and economic conditions; therefore, in their consideration the investor is at once brought back to the question of fundamental influences which we have already discussed. A bond which might profitably have been bought on a 6 per cent basis in 1921 might very reasonably still be a desirable investment in 1924 on a 5 per cent. basis. For if we assume that general interest rates from 1924 on are not going back to the high figures which prevailed in the first two or three years after the close of the war, it would be foolish indeed for us to assume that the high grade bond which could now be purchased only on a 5 per cent. basis would not be cheap unless it went back to a 6 per cent. basis.

In the foregoing discussion I have tried to sketch in outline the important general factors which bear on the investment problem for the average person. We are now in a position to apply these principles in connection with the actual investment of money. This will be attempted in the chapters which follow.

Chapter IV

INVESTING IN RAILROAD BONDS

INTELLIGENT investing in railroad bonds involves a great deal more than merely confining selections to issues which appear, from their title or technical characteristics, to be first-class or strongly protected by mortgage security. There is nothing more absurd than for one to adopt the principle of confining selections exclusively to first mortgages. From time immemorial a large class of people have been assuming that the only way to invest money safely is to put it into "first mortgages." Second mortgages are looked upon as essentially weak propositions, while third or fourth mortgages are classed, in this section of the public mind, as necessarily weak or worthless securities.

A man once submitted to me a list of railroad investments which he had been accumulating over a long series of years. He believed strongly in the principle of diversification, and in his total investment fund of about $100,000 he had exactly one hundred different first mortgage railroad bonds of $1,000 each. As his first principle for investment he had determined to concentrate on first mortgages.

He thought that the principle he followed was sound and that, therefore, there would be little or no danger of his ever losing any money. However, about one-third of his holdings had enormously depreciated in value and nearly 20 per cent. of his bonds were actually in default when he submitted his list to me.

A first mortgage railroad bond is not necessarily a sound investment. The mere fact that it is a first mortgage may have little to do with the case. There are at the present time bond obligations of the Erie Railroad system secured by second, third, fourth, fifth and sixth mortgages which are decidedly higher grade investments than certain other bonds on the Erie system which are secured by first mortgage. The Philadelphia & Reading Railroad many years ago had outstanding certain bond obligations secured by a sixth mortgage on its main lines. These bonds were higher grade in every respect than certain other first mortgage issues on parts of the same system; they sold at higher prices; they were in all ways far more strongly protected, and there was never any doubt whatever regarding the certainty of payment of both interest and principal.

Another false notion regarding the genuineness of a given railroad bond is the theory that a bond secured by a mortgage is always better than one which is not so secured. Of course, in the majority of cases this is true, but there are numerous in-

stances where a debenture bond, which is a mere promissory note, is a far better security than one which is protected by a direct mortgage lien. For a case in point, one might mention the New York Central Railroad Debenture 6s. These bonds were not secured by any mortgage whatever on the property, and they were subject to a great mass of other obligations of prior security. And yet they were a far higher grade investment and entitled to a better investment rating than hundreds of first mortgage bonds of various other railroads throughout the country.

What man, for example, who knew anything about bond values, would assert that the Chicago Great Western First 4s or the Chicago, Milwaukee & Puget Sound First 4s, were higher grade investments than New York Central Debenture 6s? And yet, the supposition regarding the certain superiority of a first mortgage railroad issue continues to persist.

Disregarding for the moment the important questions of price, yield, interest rate and length of time to maturity of any given issue, let us consider the essential facts regarding any railroad bond which the investor proposes to buy. The essential characteristics back of a good railroad bond are necessarily somewhat different from those which may be back of many other types of bonds. The outstanding fact to be considered in relation to a railroad

investment is the volume, characteristics, and stability of earning power of the particular railroad property in question.

Demonstrated earning power is the first thing that the investor should examine. Other factors, such as asset value of the property, are important, but unless earning power is satisfactory, the real security of the bond is always to be questioned, unless it is an issue which is not directly dependent on the prosperity of the railroad. There are many railroad bonds which have additional and special security aside from that which they derive as a railroad obligation.

A terminal bond, covering a railroad terminal property in a large city like New York or Chicago, might be placed in this latter class. The security back of such a bond need not necessarily depend altogether on the demonstrated earning power of the railroad itself, for it is often the case that such a bond is secured on extremely valuable real estate which would continue to be valuable even if the railroad went out of business.

But no ordinary railroad bond can be regarded as being in the highest grade group unless the earning power of the railroad itself is fully sufficient to give the company high credit and to protect the bond obligation through thick and thin. Earning power is something which is not necessarily dependent on the capital assets of the corporation or on its sup-

posed property values. Some railroads with extremely high asset values are relatively poor earners, whereas other roads, with light property values, are heavy earners. Consequently, it will be seen that, in the examination of the typical railroad report, an analysis of the balance sheet, while important, is not so important as an analysis of the operating or income results.

To study the earning power of a railroad in an intelligent way one must do a great deal more than merely glance at operating results or figure percentages of surplus income. The common rule of thumb method of a great many people is to jump to the conclusion that a railroad bond is high grade and a desirable investment if the company is earning the interest on the bond two or three times over. But while a bond may appear to have earned its interest several times over, yet, as a matter of fact, on an analysis of all the figures, it might easily be shown that the earning power is really not as genuine as the exhibits indicate.

To study earning power intelligently one must first classify railroad properties into distinct groups. Roughly speaking, American railroads can be classified into half a dozen different groups. Such groups are not merely geographical or are not determined by mere size, but are determined by types of territory penetrated and types of tonnage transported. Railroad systems operating in densely

populated territories like New England are mainly dependent for their earning power on what is known as local traffic. The freight tonnage transported by New England railroads is chiefly of the miscellaneous or high grade type. The freight hauls are mainly short ones. The handling of freight is a heavy item of expense, and consequently the compensation which the railroad must receive is bound to average higher per ton mile than in the case of railroads which handle only a few types of tonnage and transport them over long distances.

Moreover, railroad lines operating in congested territories are much more dependent on a high percentage of passenger business and are necessarily obliged to invest much larger sums in passenger service than are railroads in other types of territory. It is not only in New England, of course, that this type of railroad system exists. More and more as the United States is filling up with population and developing industrially, railroads are becoming increasingly dependent on the transportation of miscellaneous or high grade freight and on short hauls.

But we still have the great groups of properties which primarily depend for their prosperity on long haul traffic and on the transportation of great basic commodities. For example, there are the so-called coal railroads. The outstanding properties of this type are the Chesapeake & Ohio, the Norfolk & Western, the Erie, and the Baltimore & Ohio, al-

though other larger systems, such as the New York Central lines and the Pennsylvania, are also largely dependent on coal transportation for their heavy volume of business.

Properties like the Reading and the Lackawanna are known as anthracite coal roads, although in recent years they have developed an enormous amount of miscellaneous tonnage. It is a fact frequently overlooked that the Erie Railroad system, which twenty-five years ago was classed as an anthracite coal road, has now become more of a transporter of soft coal.

Throughout the entire Middle West of the United States the transportation of coal is of great importance. One must go west of the Mississippi to get away from the fields where railroads are not particularly dependent on coal tonnage for their general prosperity. Soft coal properties are not necessarily confined to one spot or one section of the country but radiate throughout a very substantial part of the more populous sections of the United States.

In the Southern States we have a distinct type of railroad which is dependent, not on coal tonnage, not on profitable short hauls, but more largely on conditions in the cotton industry. Such properties include the great Southern Railway system, the Atlantic Coast Line, the Seaboard Air Line, the Louisville & Nashville, and important parts of the Illinois Central system. The cotton industry is

extremely important to all railroads of this type, and in years of crop failure or general depression in the cotton-growing country, the earning power of all these railroads is certain to be adversely affected.

When we go farther West, we find that other important local factors permanently affect the earning power of railroads. In the entire Northwestern and most of the Central Western sections of the country, the railroads vitally depend on general agricultural conditions. The great grain-carrying roads, such as the Chicago, Milwaukee & St. Paul, the Northern Pacific, the Chicago & Northwestern, the Chicago, Great Western, and the Chicago, Burlington & Quincy are more prosperous during years of good wheat and corn crops and when good markets prevail for these crops, than at times when partial or complete crop failures occur.

In the Southwestern sections of the country we are finding, in modern times, a greater and greater dependence on industries such as petroleum production. The vast development of Oklahoma and Texas within the past decades has been tied very closely with the great expansion in the oil-producing industries. Consequently railroad properties in this section, which were formerly either more dependent on cotton conditions or were distinctly unprosperous, are now practically living on the activities created in the petroleum field.

And then we have that great group of railroads

which depend primarily on long haul traffic across great stretches of the American continent. These are the big transcontinental systems, such as the Atchison, Topeka & Santa Fe, the Union Pacific, and the Southern Pacific. Of course, a great many other properties, such as the Northwestern roads and some great Eastern roads are partially in this class also. But the big Western systems like Union Pacific have the outstanding characteristic of being transporters of long haul tonnage across the more sparsely settled sections of the West, and it is on the density of this general type of tonnage that they primarily depend for their profits.

The fact should be emphasized that the earning power of railroad systems is developed not merely through the transportation of particular types of tonnage alone, such as grain, cotton or coal. The benefits which a Northwestern railroad system gets from a big wheat crop in Dakota, when such can be sold at good prices, are not confined to the mere transportation of wheat. The railroad's greatest benefits are derived from the resulting prosperity of the people in that section, as this naturally develops tonnage and business on a healthy scale. In other words, general prosperity replaces depression in that section.

In the Southern states, during the past few years, the cotton crops have not been heavy, but the prosperity of the South has been great because of the

world demand for cotton and the high prices obtained. This is directly reflected in the earning power of the Southern systems, and their tonnage of all types of freight has expanded to very high figures.

It will be seen, therefore, that the investor in railroad securities must first determine what type of property to invest in. If he purchases a bond secured on a property like Norfolk & Western, he is, to a considerable extent, investing in the soft coal industry. If he purchases an obligation of the St. Paul System, he is investing primarily in agricultural conditions in the Northwest, and so on.

But when he has gone thus far he has only begun his study of railroad bonds. He must then begin an analysis of the particular property in which he proposes to invest. Under the modern method of uniform accounting required by the Interstate Commerce Commission, every railroad in the country must report its operations and condition on a uniform standard. Figures of every kind are available for the man who will take the trouble to examine them.

The investor should first turn to what are known as the physical exhibits. These will show him the volume and type of freight tonnage transported by the railroad. By comparison with previous years and with results on properties of similar characteristics, he will immediately see whether the prop-

erty is holding its own, expanding or declining in volume of business. By comparison with other properties, he will know whether the company is getting its share of business. He will also ascertain what business is derived from the railroad's own efforts and what business is received from connecting lines.

He will then familiarize himself with the mileage of the property, the amount and character of the equipment, comparing these over a series of years, and also compare the trend in the density of both freight and passenger business over a series of years, the trend of the train load and the average earnings per train mile. If all these figures are tending to show improvement — a fact which can be ascertained with very light study — the railroad's business stability is at once demonstrated. Having satisfied himself as to these facts, he is then in a position to examine the income account.

A railroad income account is only intelligible if examined by comparison over a series of years and by comparison with other properties doing a similar type of business. In order to make such comparisons it is necessary to reduce earnings to a mileage basis, that is to say, one must know the amount of business done *per mile of road* for each year. Only in this way can railroad earnings be intelligently understood and compared with those of other properties or with the prior earnings of the same road.

A railroad might double its total revenues but if in the same time it has doubled its operated mileage, there has really been no increase. On the other hand, if its mileage has not increased or has increased in less proportion than its volume of business, then there has been a real growth. By the same token, one must use mileage figures in comparing one property with another.

As an illustration, let us take two railroads like the Erie and the New York Central. The Erie directly operates about 2,000 miles of road. The New York Central directly operates about 6,900 miles of road. Consequently, while the total volume of business on the New York Central in a recent year amounted to about $420,000,000 and that of the Erie was only about $118,000,000, it will be found that when we reduce the earnings of both to a mileage basis, the gross operating revenues on the Erie lines were about $57,000 per mile as compared with about $61,000 per mile on the New York Central.

All the income figures should be examined on the mileage basis. Gross operating revenues, however, are by no means conclusive. The real figures to analyze are the operating expenses. These are divided into two great classifications, one being maintenance costs and the other transportation costs. Maintenance costs are sub-divided into maintenance of road and maintenance of equipment. In the maintenance figures one can generally find the

strong or weak points in the operating exhibit of the property. If a railroad is making liberal expenditures for maintenance, it is bound to be in a healthier condition than if it is not. Maintenance expenditures should necessarily expand with increasing business and contract with declining business. They should, however, as a general proposition, always represent a substantial proportion, in common practice usually over 35 per cent. of total operating costs, and ranging up to even 50 per cent. in many instances.

A railroad of the average type which continually reports low maintenance costs is almost certain to be running down, and often investors have been misled by a superficial showing of large net earnings when, as a matter of fact, the property has been allowed to go to pieces. On the other hand, it has often been the case that too much money has been put into maintenance charges. This process is what is known as "concealing profits," and years ago, when there was much political agitation regarding the big earnings of certain railroads, large amounts were often concealed through bookkeeping methods which swelled the maintenance charges.

Transportation costs are self-explanatory. They should average approximately the same per mile on all railroads of generally similar type. Of course, in times of high costs like the present, when wages are double what they were a decade ago and material

costs are very high, both maintenance and transportation expenses for the average system persistently range at extremely high figures.

But when in making comparisons between properties of distinctly similar type, we find one railroad with transportation costs persistently ranging far higher than the average, the answer generally is found in poor or deficient management or some other fundamental weakness. The other items of expense in income statements, such as taxes, rental and equipment and various miscellaneous charges, are easily analyzed and do not present any great difficulty when comparisons are made.

The final result, which gives us the income available for fixed charges, is the figure of primary interest to the bond investor. If he has examined all the prior figures intelligently he has now reached a point where he can judge intelligently as to the genuine stability of earning power back of his bond. If after such examination he finds no weakness in the exhibit and the available income for fixed charges is largely in excess of the interest requirement on the bond he proposes to purchase, he is then in a position to examine the bond itself.

Every individual bond has its own particular characteristics. It may be a first mortgage bond covering an entire railroad system or the main stem of a system, such as the New York Central First Mortgage 3½s. It may be a second or third mortgage on

the main lines and perhaps a first mortgage on certain branch lines. If such, it will generally be called a consolidated mortgage. It may be secured by a junior mortgage on the main lines, by a second or third mortgage on some branches, and perhaps by a first mortgage on other branches. Such a bond is generally classed as a first and general mortgage. There are many other types. If, as is often the case, it is secured not at all on the main lines, but on a group of branches or extensions, by a first or junior mortgage, it may be entitled a general mortgage or a unified mortgage. The Louisville & Nashville Unified 4s are this type of security.

The various types of railroad bonds have, like almost everything else, been created as the result of circumstances or experience. The needs of the hour for the particular company and the kinds of bonds which appear to be the most popular in the public mind, have generally determined the types which have been created. In modern times there have appeared a great many so-called "blanket" mortgages. A blanket mortgage is an issue which is supposed to cover, by direct lien, all of the properties which the railroad owns, but subject to prior mortgages which already exist.

Many so-called mortgages are also refunding mortgages. The refunding mortgage is generally a large issue, sometimes well secured, and sometimes poorly secured, which provides, in a definite way,

for the retirement of underlying or prior liens as they mature. But there are many variations in the types of refunding mortgages created. In some cases all underlying mortgages are what is known as " closed " and the refunding mortgage takes their places when they mature. In other cases, the underlying mortgages may be extended as circumstances warrant, and in such instances the refunding issue remains subject to such extensions.

All of these technical conditions, however, while vital, have not the same importance to the investor as the demonstrated earning power of the property itself. A refunding mortgage may be subject in security to a vast amount of other obligations and yet be extremely high grade in quality. The Pennsylvania Railroad General Mortgage, which is secured by second, third, fourth and fifth liens, being subject to prior mortgages, some secured on dividends and some secured on the main lines and which amount in the aggregate to more than $100,000,000, is as high grade, from the investment point of view, as the Union Pacific first 4 per cent. issue which covers the main line from Council Bluffs, Iowa, to Ogden, Utah, and many important branches, by an absolute first lien.

The old New York & Erie first, second, third, fourth and fifth mortgages, which cover the Erie main line across New York State, are fully as high grade investments as are the New York Central

First 3½s. This may seem strange, but if one will examine the facts one will find that these Erie mortgages are outstanding at only about $27,000 per mile altogether, and that if the property covered were ever sold at forced sale, it would bring a great many times the face value of all these bonds. This also would, of course, be true of the New York Central First Mortgage which is outstanding at the rate of about $35,000 per mile.

The problem for the investor then resolves itself down to the question of his preference in length of time a given bond may run, its price, its yield and its market. If any particular bond has met the tests of stability in earning power and other characteristics which I have already outlined, it is certain to be given a high investment rating, such as *Aaa*, by Moody's. It may be a bond running five years or one running one hundred years. It may be a first mortgage, a consolidated mortgage, a debenture or a divisional bond. The rating would have nothing to do with matters of price or interest rate paid, and little to do with its technical description. The investor must determine for himself whether he wants a short term or a long term bond. He must determine whether he wants a yield of 6 per cent. or will be satisfied with a yield of 4 per cent.

To determine these questions he must, of course, give consideration to the general fundamental influ-

ences which affect the price level of all securities at any given time and which I have outlined in previous chapters. He cannot become a successful investor in railroad bonds or in any other securities unless he gives due regard to seasonal influences and to the general trend of the money market, business conditions, and so on.

The ideal time to invest in long term, high grade railroad obligations, as in other high grade bonds, is during a period of relatively high interest rates and general unsettlement such as we had, for example, in 1920 and 1921. These are the periods in which bargains can be secured. But in all periods genuine security can also be obtained provided the investor is satisfied to receive the prevailing interest return.

I might add that it is generally well for the investor, if possible, to select a bond which sells at a discount, if he can, rather than one which sells at a premium. The man who buys a high grade bond at 98 on an income basis need have no problem ever arise in his mind regarding the question of change until maturity. He will be sure to get par at maturity and his interest meanwhile. On the other hand, one who buys a high grade bond at 110, which carries a high interest rate, must remember that as the bond approaches maturity, it will recede to par in price and he will, in the course of time, lose his premium. Of course, this premium is absorbed in

his income yield, but the average investor, who is not an expert, is apt to forget this and think he is losing some principal when, as a matter of fact, he really is not. He confuses his income with his principal simply because he has a premium.

Chapter V

INVESTING IN RAILROAD STOCKS

IN approaching the problem of investment in railroad stocks, many of the same questions which are raised in bond investing must necessarily be considered. While a stock is a very different thing from a bond, it is nevertheless true that the strength of a railroad stock, from the investment point of view, is quite as definitely dependent on the general characteristics and demonstrated earning power of the property as is the railroad bond.

But stocks as a class are necessarily in a less secure and less protected position than is the average bond. It does not necessarily follow, however, that all stocks are poorer investments than all bonds. Many a stock issue is a high grade investment, and often a given stock is entitled to a higher investment rating than are some mortgage bonds.

As in the case of bonds, there are various types of stock issues. In the railroad field, however, the stock classification is comparatively simple. Ordinarily, we have simply a preferred stock and a common stock, and usually the preferred stock issue of a railroad is of the ordinary type which simply has

preference as to a certain dividend payment before the common stockholders are entitled to any return. The preference in preferred stock issues varies in particular cases. Whereas Atchison, Topeka & Santa Fe preferred has a prior right to 5 per cent. annual dividends and also a preference over the common stock in its claim on assets, the preferred stock issue of the Chicago, St. Paul, Minneapolis & Omaha has preference only to 7 per cent. dividends but has no preference as to assets. There is no fixed rule applying to preferred stock requirements. In some cases dividends are cumulative and in some cases not. In the majority of instances, railroad preferred stocks are non-cumulative.

The investor who contemplates buying a railroad stock, be it preferred or common, must start his investigation by exactly the same methods that are applied when he contemplates investing in railroad bonds. He must follow through the financial exhibits, the operating figures, and the general earning power of the property. He must necessarily make comparisons with results in prior years and with results shown by other properties of the same general type.

But instead of being primarily interested in the net or available income required for payment of fixed charges, his primary interest is in the amount of surplus reported by the road which is available for dividend payments. This question of "surplus

available for dividends" is an extremely vital one and is very frequently misunderstood. For example, a standard railroad property like the Atchison, Topeka & Santa Fe might report in any one year a surplus, after payment of fixed charges, which would apparently be equal to 15 per cent. on the outstanding capital stock. Many investors, therefore, immediately jump to the conclusion that no less than 15 per cent. is available for dividend payments; therefore they do not understand why the company is paying only 7 per cent. when, as a matter of fact, it is reporting 15 per cent. as available for this purpose.

The confusion is due to the false assumption that the entire surplus reported by the company in its statement is actually available for dividend disbursements. In the great majority of cases this is not true at all. Any railroad of the ordinary type, which paid out in dividends its entire surplus revenues from year to year, would soon find itself in financial difficulties. Railroad revenues are subject to wide fluctuations, and if a stable dividend policy is to be maintained, a wise management will set aside each year a substantial portion of its earnings for reserve against leaner years. This is sound business policy which applies to all commercial and industrial enterprises in the corporate form.

Any examination of the different railroad reports

will clearly show that it is very seldom the case that a railroad can afford to pay out its entire surplus in dividends, even though its revenues are unusually stable and its earnings remain at a high percentage from year to year.

Practically every railroad in the United States finds it necessary to *re-invest a substantial amount of its profits in the road itself,* and any company which does not attempt to follow a sound policy of re-investment cannot remain in a healthy state for very long.

On the other hand, the company which makes a feature of its re-investment policy and puts back each year a high proportion of its surplus into the property, steadily increases its credit, improves its facilities and builds up its business in a sound and permanent way.

The Atchison, Topeka & Santa Fe system is a case in point. During more than twenty years this railroad persisted in the policy of limiting the dividend on its common stock to 6 per cent. per annum, only recently increasing the rate to 7 per cent. In many years it has earned more than twice its dividend, but an examination of its financial exhibits will show that for nearly a generation the company has each year been developing and building up its property out of earnings. At the present time it is in a remarkably strong position from a financial

standpoint. Its accumulated reserves and vast surplus which have gone back into the property to-day probably amount to more than the entire worth of the railroad system when it was reorganized a generation ago.

It is primarily because of this sound financial policy that its credit and consequently its securities stand on so high an investment plane to-day. The common stock of the Atchison, Topeka & Santa Fe is more truly an investment of high grade type than many hundreds of railroad bonds which are technically secured by the formality of mortgage liens.

It will, therefore, be seen that in considering the investment position of railroad stock issues, the financial policy followed by the management over a reasonably long term of years is always extremely vital. While the bond investor, in making a selection of a specific kind, can, in many cases, largely ignore the financial policy, this is not true of the stock investor. To return to our illustration of Erie Railroad bonds mentioned in the last chapter, I would point out that the old first mortgages of the Erie Railroad system have always remained secure and good and have continuously sold on an investment basis throughout all the reorganizations of the Erie system. This is because their security has always been ample. They were a lien prior to so many other obligations that even the poorest

possible management and the most unsound financial policy cannot disturb them.

But in the case of railroad stock issues, which are necessarily in a junior position as compared with bond obligations on the same system, the soundness of the management and its financial policy are paramount.

Many years ago the Pennsylvania Railroad Company continually followed a policy of turning back into the property each year about 50 per cent. of its surplus earnings and paid out only about 50 per cent. in dividends. This traditional policy was the one great thing which made Pennsylvania Railroad stock for many years practically the premier railroad stock investment in this country. In later years the Pennsylvania management, like that of many other railroads, has not been able to adhere closely to this plan. Through no fault of its own, it has been impossible for it to avoid the expenditure of enormous amounts of new capital, much only indirectly productive, and this has placed a burden on the company which did not exist in the old days. But the closer a railroad management can adhere to this general principle, the better its credit will be and the sounder its junior securities will remain as investments.

Consequently, the investor in railroad stocks should be directly interested in the capital liabilities of the company and the general state of its

finances. This will necessarily lead him more directly to the company's balance sheet exhibit than might be the case with many bond investors.

American railroads are capitalized on all sorts of bases, the type of capitalization usually having evolved out of the necessities and experiences of the past. A very large percentage of the older railroad systems in this country have been the outgrowths of reorganizations and consolidations. During the period from 1892 to 1899 more than 60 per cent. of the railroad mileage in the United States went into the receivers' hands and the properties were reorganized. Some of these reorganizations were extremely drastic and eliminated heavy capital liabilities. Others were only moderately drastic, and such reorganized companies were obliged to carry along a substantial part of the liabilities created under earlier managements.

Thus we find that in the railroad field a vast diversity of capital liabilities is to be found. Take, for example, a company like the New York Central Railroad. The present New York Central Railroad is the outgrowth of a merger, in 1914, of the old New York Central & Hudson River Railroad with the Lake Shore & Michigan Southern Railway and a number of other properties which were formerly controlled but not directly operated. In this merger various securities of divisional properties were assumed, certain securities were retired, others were

created. In addition to this, the older companies had years before assumed many liabilities of their own in the shape of rental guarantees, guarantees on bond issues, and many partial guarantees. Thus in this system alone we find a variety of bond obligations as first charges against earnings, a considerable number of lease or rental guarantees which are direct charges against earnings, a number of sinking fund requirements for bond issues and other items of importance, all of which must be provided for before any money is available for the payment of dividends.

The same general situation applies to all of the large railroad systems. In many cases the capitalization liabilities of a railroad appear to be in an unbalanced condition. In other words, its bond obligations may, and often do, represent a very high percentage of its total capitalization. In such instances, it is usually the case that the stock issues are weak as investments. If a railroad finds it necessary to consume, say 80 per cent. of its total earned surplus in paying actual fixed charges, it generally has little money left to use for dividends or for improvements. Other things being equal, the best railroad stock investment is usually one where the bond liabilities represent less than 50 per cent. of the total capitalization and where the general earning power is sound and satisfactory.

A case in point is that of the Delaware, Lacka-

wanna & Western Railroad. This company has practically no direct bonded debt of its own and its fixed charge obligations mainly represent dividend guarantees on stocks of leased lines. But these dividend guarantees are not a heavy burden and, as a result, a very heavy surplus is available in all normal years for dividend disbursements and for property improvements. An examination of this company's exhibits for a quarter-century will show that during this period the company has put back into the property out of earnings far more than the amount of its total capital liabilities. This is the primary reason why the stock of the Delaware, Lackawanna & Western has been a high grade investment for a long series of years.

The reverse situation is well demonstrated by the history of the New York, New Haven & Hartford during the past two decades. Many years ago the New Haven properties were looked upon as being among the best in the country and the New Haven stock enjoyed a favorable reputation as a sound and seasoned investment. The policy of the company in those days was to keep down its capital liabilities and its fixed charges to the minimum. By the terms of its charter the New Haven property was not permitted to place any mortgage whatever on its main lines and its only bond obligations and other fixed charges consisted of assumed and guaranteed bonds on branch lines and certain rental

guarantees which it had assumed from time to time. As long as this condition continued, the holder of New Haven stock was blessed with a high grade and well protected investment.

But in later years the New Haven policy changed. An era of expansion set in which may or may not have been necessary. Competing lines were bought up, the company went into the business of operating trolley lines, steamboat companies, and lighting plants, and then attempted to acquire control of all competing railroads in its territory. The matter of capital structure appeared to be completely disregarded and in the course of time the management found itself with a company which was heavily overloaded with unprofitable investments and unwieldy liabilities. This situation was necessarily accompanied by the downfall of its credit; therefore, in the course of a few short years, the stock of the New Haven Railroad, which had been a high grade investment for so long a time, promptly became a doubtful speculation.

It should be realized that all railroad stocks need not be appraised according to the same exact methods. While the general factors which affect stock investment values are broadly the same for all railroads, a different degree of emphasis should be laid on different factors in different types of railroads. An Eastern railroad property in a section like New England or the middle Atlantic states, is necessarily

more stable in its earning power than a Western or a Southern property. On the other hand, the possibilities of rapid growth in earning power are not usually so great on Eastern properties. Railroad traffic will develop roughly as population density grows in a given territory. In the Eastern states the ratio of growth in population is generally lower than in the Western and less populous sections of the country.

Consequently, there are periods when it may prove to great advantage for a man to invest in a Western rather than an Eastern railroad stock, especially if he is interested in the improvement in the quality of his investment and possible increase in income return during the years to follow. For example, about twenty years ago Union Pacific common stock and New York Central stock were selling at approximately the same prices, although New York Central was then paying a slightly higher dividend. The investor who then considered the relative merits of these two stocks might have wisely given special weight to the fact that the following twenty years would witness a far greater ratio of population increase in the Union Pacific territory than in the New York Central territory. While Union Pacific was a far less seasoned stock than New York Central, it was distinctly a better investment purchase. Since that time Union Pacific has increased its dividends and since 1906 has been regularly paying

from 8 to 10 per cent. New York Central, on the other hand, for many years was obliged to cut its dividend payment to 5 per cent. and only recently has restored the figure to the 7 per cent. of earlier days.

To have bought Union Pacific in 1904 was, therefore, not a speculation, but a farseeing, wise investment. The company was even then earning far more than its dividend requirement and in no year since that time has it failed to earn much more than its dividend. During the twenty-year period, the policy of pouring back into the property millions of dollars of surplus earnings has been persistently followed and, consequently, the Union Pacific property to-day is one of the highest grade railroads in the United States. The New York Central, because of its great traffic stability and favorable territory, has also presented a good record, but its average surplus earnings have never approached those reported by the Union Pacific and have never shown the same steady ratio of growth. For some years the New York Central found it difficult to re-invest any of its surplus earnings and as a consequence its fixed charges grew faster than would otherwise have been necessary.

As in the case of investment in railroad bonds, many general factors should be given vital consideration, aside from the matters of demonstrated earning power, financial structure, characteristics of

territory and of tonnage, and so forth. Character of management is almost always pretty directly reflected by the records of results. Questions of banking control or financial alliances, while interesting, do not nowadays loom nearly so large as they did twenty years ago. American railroads are, in these times, so completely under governmental supervision and regulation that the possibilities of unsound financial methods are largely eliminated.

Chapter VI

PICKING PUBLIC UTILITY BONDS

THE problem of investing in public utility securities is necessarily somewhat more complicated than investment in railroads. The title "public utilities" includes several groups or types which in many ways are distinctly different. As generally understood, public utilities include all so-called franchise corporations, such as telephone and telegraph companies, gas companies, water supply companies, electric light and power, hydroelectric and all types of electric traction corporations.

In brief, a public utility is a corporation which it is assumed supplies some public need and which is given a more or less exclusive right or privilege to supply that need.

Let us first take up the problem of investment in telephone and telegraph bonds. The telephone industry is comparatively a new one. Its whole history from the time of its inception about forty years ago, has been one of experiment and development. It has taken a long series of years, the development of a large number of inventions, and the slow but steady education of the public to bring

the telephone into general use and make it one of the great necessities of modern civilization. After this long period of development we have in this country finally arrived at the time when to the average man the telephone has become an essential part of his life and general activities and is no longer looked upon as a luxury for the few.

As a result of this development the telephone industry in recent years has become pretty thoroughly stabilized. Telephone securities, as a class, are today a far different type of investment than they were even fifteen years ago. In those days, the country was dotted with many local telephone systems and so-called independent companies which competed with each other. In many cases unsatisfactory or indifferent service was given, and as a result the telephone companies were financially or permanently successful in only a few cases.

The telephone business is the type of industry which from its very nature requires operation on a large scale and practically without competition. It is what is known as a natural monopoly. Successful telephone service can hardly be expected unless an exclusive right to operation throughout a specified territory is given to a single company. Where two telephone companies exist in a single city side by side, confusion and limited service are inevitable. In such instances, it is necessary for a business man or an individual to have two telephones

in his house or office to secure the service which he naturally wants.

It has taken many years of experience to convince the public of this fact. But to-day it is pretty generally recognized that we can have good telephone service only by allowing one organization or one group to operate the entire industry.

Telephone service in the United States to-day, taken as a whole, is far superior to that of any other country in the world. It is almost completely controlled and dominated by the American Telephone & Telegraph Company, and consequently the investor in telephone bonds almost inevitably must put his money into issues of this company or of its many subsidiaries. A consideration, therefore, of telephone bond investments involves a consideration of the American Telephone & Telegraph system and the matters which are connected with it.

It should be realized that the investor in a telephone bond has something more to do than merely to examine the financial or income records of this company and its subsidiaries. He must first of all recognize the fact that the telephone industry, like the railroad industry, is carried on under more or less governmental regulation. This regulation defines the policies of the company to a large extent, limits the rates charged, but at the same time protects the company in its legitimate rights. Of course, there are, as in the case of the railroads,

political problems continually coming up for discussion, and changes in public opinion are important factors in determining the success or failure of the business.

But the investor will begin his study of these things by making a close examination of operating results. If any particular telephone company is not prospering and, although giving efficient service, is apparently making little or no money, the answer generally will be found in poor management or in unsound financial arrangements. Telephone companies, like all other corporations, are subject to human errors and mistakes of judgment, and some of the old independent companies went on the rocks simply because the management was too visionary, too speculative, or financially too weak. But with at least 90 per cent. of the telephone industry today in the hands of one great controlling and operating corporation, these weaknesses are largely eliminated.

The test, therefore, in buying a typical telephone bond is to determine whether the managerial policy of the American Telephone & Telegraph group is substantially what it should be. When this fact is determined, the further matters of analyzing and studying particular securities come in for consideration.

Necessarily there is much difference in quality in the various bond obligations of the American Tele-

phone system and its subsidiaries. A great many issues are mortgages on local operating properties, some very successful, some only moderately successful, and some not at all successful. In most cases, such obligations are not guaranteed by the parent concern and, therefore, their security must depend on the actual operating results of the subsidiary itself.

An important consideration for every telephone bond investor is the question of location of territory and that of density of population. A telephone property located in a sparsely settled, unstable or stagnant portion of the country is necessarily a poorer issue than one located in a thickly populated territory like New York City. Furthermore, a bond secured on property in a territory showing a steady or rapid growth in population, which promises to be permanent, is often to be preferred to a bond secured on a stable property in a substantial territory but which promises little in business growth in the future.

A case in point is that of the Pacific Telephone & Telegraph Company. Because of the remarkable and persistent growth of the Pacific Coast states in population and wealth during the past decade, the credit of the Pacific Telephone & Telegraph Company is to-day on a far higher plane than was the case ten or fifteen years ago. It will be noted that the outstanding mortgages of this company have

in recent years sold at unusually high prices, and the bonds have remained very stable even in times of depression and unsettlement. On the other hand, certain local Eastern telephone properties, while showing growth in volume of business, have often suffered because of over-regulation and arbitrary restriction of rates and, therefore, have not been able to increase their profits in any large degree.

A fact in relation to telephone securities which should be strongly emphasized is that they represent a type of industry which is not seriously affected by the business cycle or by a sharp change from prosperity to depression. During periods of business unsettlement or depression, the telephone business remains practically as heavy as at other times. A reference to the unsettled years of the war period and the few years after, when ordinary industries showed vast fluctuations in earning power, will show that the telephone industry reported actual improvement. This is an outstanding fact which emphasizes the stability of the telephone business and the consequent attractiveness of sound telephone obligations.

In the selection of telephone bonds every issue should naturally be put to the test of past records in earning power of the property, as well as current exhibits and prospects for the future. A given telephone issue, unless of a very junior type, will

respond in intrinsic strength to changing earning power just like any other issue. For example, a telephone bond properly secured by mortgage or other protection, will be a much better investment if the property behind the bond has a heavy asset value and has earned the interest requirements several times over for a series of years, than one which has not the same asset protection and which has only recently shown substantial earning power. The principles for analyzing bond issues, which have already been discussed and will be discussed in other chapters, apply as directly to telephone securities as to any others.

The telegraph industry is also one which by its very nature is a natural monopoly. In this country two great concerns, the Western Union Telegraph Company and the Postal Telegraph Company, practically divide the field. These two companies handle practically all the business, and, through an interchange arrangement, to all intents and purposes operate as one. The industry is one which depends for its success on giving good service and on satisfying the public demand. But it is also a government-regulated business and has the same political problems to face as have the telephone companies.

The two great telegraph companies in this country are well managed and have been for many years. They have outstanding a limited number of securities, practically all of which are protected by long

years of stability in earning power and large and growing asset values.

The greatest modern development in the public utility field, however, has been among those enterprises which furnish gas and electric light, electric power and electric traction. The development of these industries has been an outstanding characteristic in the growth of the country during the past thirty years. To-day these industries are completely stabilized and the lighting and power companies particularly have become such an essential and permanent part of our modern life that they could in no sense be dispensed with or greatly curtailed.

As a general proposition, the most attractive and highest grade public utility bonds are those of gas and electric lighting concerns. There are thousands of issues in this field and every year witnesses the creation of a great many more.

There are all kinds of lighting company bonds: those secured by first mortgages on specific properties; those secured by second or junior mortgages; those secured by consolidated or general mortgages; those which are secured not on one but on a group or series of plants. In addition, there are in the markets to-day hundreds of public utility bonds which are indirectly secured on properties by the deposit of collateral which is itself sometimes secured by mortgage and sometimes not.

More than in any other field, there are many

bonds outstanding which are secured not on bond collateral but on stock collateral. Some of these latter are necessarily in a doubtful position from the genuine investment standpoint.

The wise investor in public utility bonds who is giving first thought to the security of his principal will naturally give preference to those issues which are directly secured on stable properties which operate in centers of large population or in locations which promise steady expansion in the future. Where other things are relatively equal, a lighting company bond secured by a direct mortgage, in a city like New York or Chicago, is naturally better than one similarly secured in a town or city of ten or twenty thousand people or in a rural district. There are probably no higher grade lighting company bonds in the United States than the underlying mortgages on the New York and Brooklyn Edison properties, and the market prices of these bonds directly reflect this fact.

Gas company bonds are to be judged by the same general principles that we have applied to electric light issues. As a sound investment principle, preference should naturally be given to companies located in the larger cities rather than in the small towns or country districts.

In recent years the development of hydroelectric enterprises has gone steadily forward. Hydroelectric undertakings, where soundly planned and car-

ried forward with intelligence and ability, are among the most stable of American utility enterprises. The time is no doubt coming when hydroelectric development will be carried much further. Consequently, well chosen bond investments in this field are to be strongly recommended. Some of these enterprises have, in the past decade or so, demonstrated their stability and strength very effectively. Companies like the Niagara Falls Power Company, the Northern States Power Company, the Pennsylvania Water & Power Company, and the great hydroelectric undertakings on the Pacific Coast, have gone far in the general development of this industry. There have been very few instances where hydroelectric enterprises, provided they are soundly planned and ably managed, have not more than made good. Bond selections in this field, therefore, are to be strongly recommended.

One section of the public utility field which must be given somewhat independent consideration is that of the electric tractions. It was at one time thought that the electric traction business would become as stable, from a revenue standpoint, as the steam railroad industry. But this has not proven to be the case. Electric street railways for the first twenty years of their development and operation, appeared to have become an absolute necessity just as had the electric light and the telephone. Furthermore, it was generally assumed that because of franchise

protection, street railways would be certain to increase in earning power and profits in direct ratio with the growth of wealth and population. But the rising costs of operation during the last dozen years and the wide introduction of the automobile and so-called "jitney" service have brought the street railway industry into a much more doubtful position.

As a consequence of this change, the investment of money in street railway bonds requires great discrimination. Even when one confines oneself to so-called underlying mortgages on street railways, one should act with unusual care.

There are, of course, a very large number of public utility organizations which supply all types of public service, except telephone and telegraph service.

The public utility industry has gone through a far-reaching but natural evolution within the last twenty years. Nowadays, groups of large so-called managing and holding corporations operate the great bulk of these utilities. These large holding corporations control and handle the finances as well as supply the service rendered. Of course, these groups vary in credit characteristics, in matters of policy, and in quality of management.

The existence of this great structure of holding and management companies has opened up to the investor a very broad field for the placing of his

funds. There are many opportunities for diversification of investment capital which did not exist twenty years ago. A man may, through investing in a holding company obligation, actually diversify his funds into every section of the United States, and still have his money entirely in a few issues. The selection of holding company securities necessarily involves special study in each case. Sound methods for passing upon individual issues, involving a research of past and an examination of current results, an analysis of territories covered and the public attitude in those territories, are all essential.

Another group of public utility issues are the various private corporations which supply water to towns and cities. While a high percentage of the water supply plants throughout the United States are owned and operated by the municipalities themselves, yet there are numerous cases where the water supply is furnished by private corporations.

As a general proposition, the properly protected bond obligation of a water supply company is a very sound investment. There is hardly any industry in this country which is more stable in earning power than a water supply company, provided it has a sound franchise and a permanently protected field. The most essential commodity in the world for everybody is water, and the use of water cannot fluctuate to any great extent with changes in business conditions. Consequently the only vital problem with

a water supply company is to be certain of having available water and having reserve supplies sufficient to eliminate the damages of shortage. Water supply bonds for the most part sell on a high investment basis and are favorably regarded in all the conservative investment markets.

In the general field of public utility bonds, there are opportunities for investment diversification which do not exist in an industry like steam railroads. While one can follow a limited diversification policy in the selection of railroad investments, it is also true that railroads, as a whole, respond to certain general fundamental influences and to some degree, at least, rise or fall together. On the other hand, in the public utility field, the effects of fluctuating business conditions and the rise or fall of prosperity are never so far-reaching or permanent. In brief, the element of stability in these types of industries is always very high.

Consequently, the public utility investor who places a portion of his funds in gas and electric lighting bonds, a portion in power company bonds, a portion in telephone or telegraph bonds, a portion in water bonds, and a portion in very carefully selected traction bonds, may achieve a very unusual type of general safety and sound diversification.

Chapter VII

PICKING PUBLIC UTILITY STOCKS

WITHIN the past few years the field for the safe investment of funds in the stock issues of public utility enterprises has developed enormously. A dozen years ago public utility stock investments of real character and stability were few and far between. True, we have for a long series of years witnessed the expansion of the American Telephone & Telegraph Company through successful stock financing, but in other departments of the public utility field, stock financing has been a purely latter-day development.

The reasons for this situation are not far to seek. Although public utilities, as a whole, have now become pretty thoroughly stabilized in this country, yet as compared with steam railroads, their history is a short one. Like all new industries, the question of finance has been paramount and the difficulties of securing capital for the development of new utilities have in the past involved many serious problems. It was necessary, during the first stages of development of the industry, to do a great deal of financing through the issue of mortgage bonds. To find the

capital for the proper building up of electric light and power undertakings and for the development of traction lines, the promoters and managers in past years almost inevitably found it necessary to give exceptional security to secure substantial amounts of investment capital.

If we look back over the history of the public utility field of the past twenty-five years we will notice that the development of the outstanding enterprises has been accompanied by the issuing of a great variety of bond obligations, many secured by strong, direct mortgages, others by consolidated or junior mortgages and many by other types of collateral.

In addition to this, the history of the movement has, in the latter years at least, been largely a consolidation development. The inception and growth of the great public utility managing and holding organizations has involved the merging of many types of producing plants, large and small, practically all of which had already been bonded or placed under some type of financial obligations. Thus we find that in the public utility field, as in the railroad field, many types of securities have been created and exist to-day as a direct result of circumstance or necessity.

It is true that a few public utility undertakings of earlier days were financed mainly through the issue of capital stocks. This was notably true of a

number of electric lighting companies in the large cities like New York, Brooklyn, Detroit, and Boston. These companies, even twenty-five years ago, were financing their needs mainly through issues of stock and only occasionally put out mortgage obligations of any kind. The result of this policy is shown in their condition to-day. These large companies are outstanding as concerns which are burdened with relatively small fixed charges and in most cases they have rewarded their stockholders with liberal and increasing dividends for many years.

With the modern stabilization of the industry, however, the tendency towards stock financing has grown with great rapidity. To-day the best of the public utility operating companies in the fields of gas and electric light and power are doing more and more financing, through the issue of preferred and common stocks. Notable instances of this are cases like the Pacific Gas & Electric Company, the Southern California Edison Company, the Duquesne Light Company, the Detroit Edison Company, the Edison Electric Illuminating Company of Boston, and numerous smaller plants.

When we turn to the larger field of public utility groups represented by holding or managing companies, we find that the best and most successful of them are more and more tending to issue stock obligations when they need new capital for extensions or improvements, rather than to issue additional

amounts of bonds even when they would find it an easy matter to float fixed interest-bearing securities.

There are several sound reasons why public utility stock investments have been placed on the market so successfully during the past few years. In the first place, the more seasoned and stabilized condition of the industry as a whole has created a great deal more confidence regarding its future success than formerly existed. The demonstrated stability of earning power of sound public utility propositions during the war years and those immediately succeeding has awakened the public mind to the fact that these companies are carrying on essential industries which are practically certain to continue in their present form or become even more stable as the years go on.

Another reason why public utility stocks have come to the front so strongly is that farseeing managements have been recognizing the great value of having employees and consumers become part owners in the companies. Persistent selling and educational campaigns have been carried on for some years among the actual consumers of public utility products and these campaigns have been so successful in educating the public that a new source for the permanent investment of capital has been found at the doors, as it were, of the companies themselves. As an illustration of this, the Pacific Gas & Electric Company and other California companies have

among their permanent common and preferred stockholders many thousands of their consumers and this situation has developed all along the line with the greatest and most efficient organizations. Beyond this, the growth of employee-ownership has reached very remarkable proportions in many sections of the United States.

But the popularity of public utility stocks, especially preferred issues, has grown with the times because of the fact that an increasing proportion of the American public are becoming investors and are constantly seeking for securities of small denominations. It is difficult to select a large number of really good bond investments in small denominations, but the field is practically unlimited for the purchase of stocks the denomination of which in no case is higher than $100. Consequently these securities are steadily spreading into broader and broader fields and among all ranks in the American army of investors.

To judge public utility stocks one must, of course, give special attention not merely to the general financial structure of the company, but to the character of its management and its managerial policy. As in the case of the steam railroad stockholder, the problems of management and current financial condition loom larger than might be the case with a bondholder who is additionally protected by a well-secured mortgage on valuable property.

In the earlier days of public utilities, it was thought that the best asset of the typical company was its franchise. At that time mortgages were often issued directly on the more or less intangible franchise value and were regarded as good investments, mainly on the theory that the franchise would continuously become more valuable as the company grew and that in any event it would always be worth much more than the physical property.

But in recent years it has been pretty well demonstrated that franchises in themselves are often of little or no value, and sometimes their terms are such as to make them develop into distinct liabilities. Take, for example, the case of the Interborough Rapid Transit Company of New York City. The contracts and franchises under which it operates were twenty years ago thought to be of unlimited value. To-day they are a great menace to the company and have resulted in almost wrecking the property during the past eight or ten years. The terms of the franchise limiting the rates which the company was guaranteed have resulted disastrously in these days of high operating costs.

Therefore, in examining a public utility property nowadays, the more indeterminate and limited the franchise is, the better it often may prove for the security holders. The real point to be considered is, not the franchise, but the ability of the company to satisfy its public through efficient operation and

the supplying of good service. Where a public utility lighting company is furnishing its public with superior service, one hears very little agitation regarding the injustice of rates, or the monopolistic character of the business which is being carried on. It is, of course, true that political agitation is always present, and there is always a small minority of noisy agitators who advocate putting the screws on the companies, wrecking them if possible, and turning the utilities over to public management. But the influence of this type of sentiment is becoming less and less effective as the industry is becoming more stable and as efficiency is developing in the service rendered.

It therefore seems to me that, from the present standpoint at least, the man who is over-concerned regarding the political dangers of investing in public utility issues, is tending to borrow trouble. Of course, there are exceptions, but as a whole the dangers of effective agitation in favor of public operation have passed. We have had many disastrous experiments during the past ten years demonstrating the economic unsoundness of the operation of utilities of this type by inefficient political bodies.

In studying public utility properties with a view to investing in their stock issues, one should first classify them into their several different types. First, there are the companies whose business is simply that of supplying gas in municipalities for

light or heat. Second, there are those companies which exclusively supply electric light and electric power in cities, towns and other concentrated centers of population. Third, there are those companies which confine their work to hydroelectric development, involving the supplying of electric power for several purposes — lighting, water and electric power for traction companies and other purposes. Fourth, there are the electric traction concerns themselves, which furnish electric railway service in the cities, the suburbs, and through the operation of interurban lines, some of which secure their power from other companies and some of which have their own power plants. Fifth, there are the companies which exclusively supply water to municipalities. And then we have, finally, the telephone and telegraph companies which confine themselves to their own particular product.

These classifications, of course, can be applied only to specific companies which concentrate wholly in these several fields. In the great majority of cases the public utility companies whose securities come on the markets do more than supply one of these types of service. While there are outstanding instances of gas supply companies, such as the Peoples Gas Light & Coke Company of Chicago, it will be found that most of the larger gas companies do much more than merely supply gas.

For example, the Consolidated Gas Company of

New York, while exclusively supplying all the gas for light and heat in Manhattan Island and certain other parts of the city, also owns the New York Edison Company from which its income is far greater than it is from the gas business. Thus any investor who puts his money into Consolidated Gas stock is really investing more in the electric light and power industry than he is in the gas industry.

This situation exists all over the country. One can purchase stock of the Commonwealth Electric Company of Chicago and his investment will be in the electric light and power industry. This would be also the case if he purchases Philadelphia Electric Company stock. But if he invests in stock of the Pacific Gas & Electric Company, he is not only an investor in gas and electric light and traction service but he is even more an investor in one of the largest and most successful hydroelectric power concerns in the United States.

This general diversification throughout different types of public utility activities is, of course, more outstanding when one invests in the obligations or stock issues of the so-called holding or managing companies. If one purchases stock of the Electric Bond & Share Company, for example, one immediately becomes an investor in gas, electric light and power, electric traction and hydroelectric power services distributed practically throughout the entire United States, and to some extent in foreign

countries. One's interest in this case is tied up with the success of companies like the American Power & Light Company, the Lehigh Power Securities Corporation, the American Gas & Electric Company and other concerns which themselves control operating plants throughout the American continent. So in determining on the wisdom of an investment in Electric Bond & Share Company stock, one would naturally examine not only the financial exhibits and record of this company itself, but also the financial exhibits and records of the American Power & Light Company, the American Gas & Electric Company and other holding companies which are identified with it, and then go still further and examine the exhibits of the actual operating companies which are controlled directly or indirectly.

It is only in this way, by following through the maze of underlying or overlapping activities in this greatly diversified public utility field, that one can satisfactorily analyze the position of the securities in which one invests.

It will readily be seen that this examination of subsidiary properties and operating plants is often much more important to the stockholder than to the bondholder. A bondholder in a subsidiary company like the Southwestern Power & Light Company or the Pacific Power & Light Company, need not concern himself so much about the condition of

the controlling corporation as he needs to give attention to the character of his mortgage. But the stock investor, who is in reality a partner in the whole gigantic enterprise, is necessarily interested in the proposition as a whole.

The most popular form of modern public utility stock investment is the preferred stock. There are many types of public utility preferred stocks in the markets to-day which did not exist even half a dozen years ago. We find issues which have preference as to assets and as to dividends, limited to 6 per cent. or 7 per cent. as the case may be; others having prior claim on certain dividends but sharing with the common stocks in additional dividends when such are earned; still others carrying important convertible privileges, giving the holder the right, in some cases, to convert his issue into common stock or to convert his stock into bonds. These various options which have been attached to modern public utility preferred stocks have, of course, in most cases been created as a result of necessity or for inducing investors to buy.

The convertible privilege is not a new idea. In the railroad field twenty or thirty years ago a great many convertible bonds were issued which gave the holder the right, at certain periods, to convert into stock. The theory of this scheme was that a convertible bond would appeal to a wide public who

wished to invest in something which had special security but which would rise in price with the increasing earnings of the company. Thus developed the old saying that "the convertible bond was invented for the man who had promised his wife not to speculate in stocks." For, of course, if the stock went up, the bond would go up also and thus the holder would have a chance to reap the same profit as the stockholder without running the stockholder's risks as to principal.

This theory is sound enough, the only difficulty being that it seldom works out very satisfactorily. It is only in rare cases that a convertible preferred stock gets much benefit from an improvement in the value and income of the common stock issue; for in the majority of cases the company with high credit and large current earning power does not find it necessary to offer special inducements to sell its securities. It is able to command all the capital it wants on a purely business basis and, therefore, if it puts out a preferred stock, it does not offer any fancy options.

But the primary motive in investing in a public utility preferred stock should not be the opportunity to make a "killing." This opportunity or option, if there is one, should be regarded as merely incidental. The investor's main thought should always be to consider first the intrinsic quality of

the stock itself; whether the company is overcapitalized as to prior liabilities or not; whether its demonstrated earning power and plainly visible prospects for the future justify the investment. And, most of all, whether the management is able and efficient enough to cope with the ever changing conditions in its territory, the political agitation, the dangers of injurious legislation; and, further, the financial resourcefulness of the controlling interests. When he has satisfied himself on these important points, he is in a position to consider the problem as to whether it is the time for him to buy and whether the yield which he is to receive is reasonable and satisfactory.

In the field of public utility common stocks, the speculative element, of course, stands out more strongly. But while the rapid increase in value of certain public utility common stocks, especially those of holding companies, has recently created wide interest, there are a respectable number of really high grade and seasoned common stocks in this field which have presented a splendid record as high grade investments and have returned to their owners steady and substantial and, in some cases, increasing dividends for many years. What better common stock investment could the typical investor have had during the past years than the stocks of the Commonwealth Edison Company, the Brooklyn Edison Company, the Detroit Edison Company or the Edison

Electric Illuminating Company of Boston? These are not speculative issues. They are not traded in for profit from day to day to any great extent, but have proven very lucrative things for the modern up-to-date investor to have in his strong box.

Chapter VIII

SELECTING INDUSTRIAL ISSUES

INVESTING in stocks and bonds of industrial enterprises involves many questions which do not require so much consideration in more definitely classified fields, such as the public utilities and the railroads. As generally understood in Wall Street, an industrial security is an obligation of any kind of producing or distributing concern which is not a steam railroad or a public utility. It will thus be seen that the title itself has a very broad meaning and includes so many types of productive activities that few general rules for analysis can be safely applied.

The outstanding types of industrial corporations, the securities of which are known generally in the financial markets, are the great steel and iron producing and manufacturing companies, the many concerns which carry on the business of copper production and distribution, the many great petroleum producers, the companies identified with the motor and allied industries, the great distributors, wholesale and retail, of all sorts of manufactures and miscellaneous goods, the great chain store corpora-

tions, the many concerns whose activities are confined to the textile industries, the paper and pulp manufacturers and distributors, and an unlimited number of other concerns which carry on the trade and commerce of the nation. Included in the general industrial classification are distributing and transportation concerns, the great mail order houses, steamship companies, and other activities of this type.

To consider this great maze of corporate activity as a whole, and to judge the value and desirability of its securities, it is necessary, first of all, to give special attention to the individual characteristics of each corporation. One cannot generalize as in the case of a uniform group of industries like the railroads. It is utterly foolish to compare the methods, the markets or the general financial exhibits of a chain store company with a copper producing corporation. It would be absurd to put the same tests to the stock issue of a moving picture concern that one would put to the stock issue of a company manufacturing cotton goods in New England.

But in spite of the miscellaneous character of the many producing activities classified as industrials, there are certain fundamental methods whereby one can, with great safety, judge as to the worth and value of their obligations. It is an old saying that the proof of the pudding is in the eating, and this applies with great force to all business

concerns. Demonstrated success is the one outstanding fact which justifies confidence in the outlook for any particular business, and thus the investor will always, as a first test for an industrial security, carefully consider the results already obtained. Let us, to bring this thought clearly out, examine the record of the United States Steel Corporation. Here is a company successfully making profits, through good times and bad, by the production and distribution of essential commodities without which modern civilization could not go on. The business is a competitive one to a large degree, but the main secret of success for this corporation has been its development of modern and efficient producing methods and its consolidation of producing forces on a large scale under scientific management. The United States Steel Corporation, which was the outgrowth of experiment and experience in earlier days, so dominates the steel and iron industry that only a disastrous change in its managerial policies could dislodge it as one of the great permanently embedded enterprises of the country.

The Steel Corporation does everything in the general process of the manufacture of steel products. It owns the mines from which it secures its iron ore. It owns the railroads and steamship lines which transport its raw material to its manufacturing plants. It manufactures, by means of the most modern scientific methods, all kinds and qualities of steel and

iron materials, and it has its own far-reaching organizations for the distribution and sale of these materials. It is so organized that it can distribute its products to any part of the world in competition with others.

Like many of the industrial corporations which exist to-day, the United States Steel Corporation was originally very heavily over-capitalized. But because of the type of management which has prevailed and the far-sighted policy of its owners, its securities to-day all stand on a high investment plane and even its common stock has changed, during the past two decades, from an uncertain speculation to a high grade investment. The person who to-day contemplates placing funds in the stocks of the United States Steel Corporation is highly protected in practically every way by the record which has been shown and by the current condition of the corporation. The assets back of the outstanding securities have been allowed to accumulate heavily for many years and thus, even if the business were liquidated to-day, the common stockholders would be the recipients of a great reward.

Reference to other companies in this line of business will show many of the same conditions but to lesser degree. It can be easily demonstrated, through an examination of past records and of current conditions, which steel and iron companies are worthy of attention by the investor and which are not.

There are those companies which suffer severely during periods of depression and whose financial or other resources are not great enough to enable them to go through a period of reaction. Such companies, it will be found, suffer either because of the specialized character of their business, the limited features of their markets, or because of less efficient and less far-seeing management.

One can go right down the line of typical industries and see on every hand the primary causes of success or failure. We might take, for example, the automobile industry. Considered as a whole, there has been no industry in the United States in modern times which has shown such remarkable expansion and steady growth of stability as has this industry. This remarkable growth, of course, is largely due to the development of the gasoline motor and the steady increase in its use by the masses throughout the country. And yet, while the industry as a whole has progressed and grown larger and more stable from year to year, it is a very easy matter to pick out the particular companies which present a long record of success and those companies which have either failed to make good or are constantly in a precarious condition. The test is in the record, and the favorable records of the successful companies, for the most part, have been brought about by superior methods of management. Automobile manufacturing and selling is a comparatively new

industry, and the former generation knew nothing about it. Consequently the last twenty years have been a period of experiment to a very large extent. The successful automobile companies have not necessarily had the advantages of superior financial backing, as some of the most outstanding successes have started from practically nothing but an idea. The Ford Motor Company, the most successful organization of its type in the world, started business practically without a dollar. And yet to-day it is richer than any other concern of its size in the world. The secret of success has always been tied very closely to its managerial policy.

If we turn to other typical industries, such as, for example, the mail order concerns or the great chain store companies, we will again find that the outstanding factor has been superior management in the case of those which have succeeded greatly. There is no monopoly in a mail order or chain store business or any similar type of enterprise. And yet some companies have made vast fortunes while others have fallen by the wayside. The success of great concerns like the Woolworth Company or Montgomery Ward & Company has been due, once more, to the wisdom and far-sighted methods of the managers.

There are, of course, certain types of industry which are affected more vitally by general fundamental influences and which sometimes come upon

hard times even under the best of managements. This is true of businesses engaged in the manufacture of textiles, of leather goods, and of many other types of manufactures. Variations in demand and supply, and the expansion or limitation of markets, affect such industries very vitally. Consequently, the element of stability is never so great as in the case of enterprises not so affected.

During the severe depression of 1920 and 1921 an enormous number of representative industrial corporations of the country suffered so severely in their earning power and financial condition that their securities declined precipitately and vast losses were incurred by the holders. This was a fact, not only with poorly managed companies, but also with many which had enjoyed the best of management and had shown great efficiency in the production or distribution of their goods. But even in this connection we will find, on an examination of records, that managerial policy had a great deal to do with their condition.

Sound management involves not only ability to produce and distribute goods successfully and efficiently, but also sound methods of financing and intelligent foresight regarding trade conditions. The great industrial concerns which have suffered the most in the period of depression were those whose managements misjudged conditions and allowed themselves to over-stock with goods or over-extend

themselves in the matter of liabilities. The concerns which foresaw the danger ahead weathered the storm for the most part far more successfully than did the others.

From what I have said it will be seen that, as a class, the securities of industrial companies are not to be looked upon as being on so stabilized a plane as are securities of public utility corporations or of steam railroads, and the market prices and general reputation of such issues bear out this fact. An industrial bond, well secured by a good mortgage, with a large margin of safety in earnings and high asset value, will generally sell in the markets lower than a similar bond with equal general security on a public utility property or a steam railroad. The same fact applies to most industrial stocks. The investment risk is almost always greater, and therefore the yield to the investor must necessarily be higher to compensate for this risk.

But because the element of stability in industrial enterprises is not so outstanding as in certain other fields, it is not to be assumed that there are no really high class investment bonds or stocks in the industrial field. The markets are full of attractive and seasoned industrial issues, and all investors who wish to diversify their investment capital intelligently should place at least a portion of their funds in well tested and strongly protected industrial securities.

The field for bond investment among industrials is far more limited than that of stock investment. While there are many industrial concerns with bond issues outstanding, the supply of such issues is relatively limited. This is largely due, of course, to the fact that the industrial activities of the country have only been converted into large units and into corporate forms within the last generation. While certain outstanding concerns have been the outcome of consolidations in the past, the majority of them have not, and have simply grown up in size with the general expansion of production and of consuming demand. The chain store companies have all of them grown from a single unit. Most of the automobile manufacturing companies have grown in this way, and while the outstanding steel and iron concerns are partly the outgrowth of consolidations, yet these consolidations have not been numerous and the plants taken in have always been limited in number. This is in striking contrast with the development which has been taking place in public utilities and steam railroads for many years past. Consequently, an industrial company of the typical order may have outstanding only one or two bond issues, whereas a railroad or public utility of the same size might easily have twenty to fifty different issues outstanding.

But in the limited field of industrial bonds there are opportunities sufficient to satisfy any discrimi-

nating buyer. The most desirable issues are, of course, always the most seasoned bonds with the best mortgage protection and with a high percentage of earning power back of them. A bond like United States Steel Corporation 5s is, so far as security is concerned, as high grade as one could wish, and its price quite reflects this fact. Other issues, however, are plentiful which generally yield more than the current rate of interest, sometimes offer very distinct bargains, and at the same time are as strongly protected as any railroad bond.

But naturally the industrial bond which is an obligation of a company whose record has demonstrated special stability, is always to be preferred to one which has not been uniformly protected in this way. Many industrial bonds have special mortgage security which gives them unusual strength. Such issues will stand up well even in periods of extremely poor business. For example, a bond like Armour & Company Real Estate 4½s will always hold a high investment position because of the great value of the real estate on which it is secured, whereas another bond in the same type of industry, like Wilson & Company First 6s, is immediately affected by a bad business situation. It will be seen that one cannot overemphasize the importance of careful analysis of every industrial mortgage that one contemplates purchasing.

It is, of course, in the field of stock investments

that industrials offer the best opportunities. There are thousands of industrial stock issues quoted in the markets of the United States and nearly all of them have some element of speculative value as well as of investment worth. Confining our discussion primarily to those with real investment worth, it is possible to point out the types of issues which should be given favorable consideration.

Among the best known industrial preferred stocks which, through long periods of time, have proved their worth and steadily developed in investment stability, are outstanding issues like the American Car & Foundry preferred, American Brake Shoe & Foundry preferred, United States Steel preferred, Bethlehem Steel preferred, Railway Steel Spring preferred, and Corn Products preferred. These are all issues which were created many years ago and which, at their inception, appeared to carry serious speculative elements. But through a long record of successful management during both good times and bad, these issues have steadily grown in investment strength and have now for many years been classified as thoroughly high grade.

But an industrial preferred stock investment, like most other preferred stocks, is limited as to its future unless it carries something like a convertible privilege or shares in some way in an increase in earning power. The real investment opportunity in the industrial field has necessarily been among common

stocks or plain stock issues. This, of course, is also the field of speculative issues, but the type of common stocks which can be classified as primarily investment propositions are easily distinguished by a careful examination of the enterprises themselves and by the past records and current policies.

Probably it would be hard to find many more satisfactory and better investments than industrial stocks like General Electric, Pullman Company, American Car & Foundry Company common or the F. W. Woolworth Company. This could not always be said of these issues for all of them in their early days were speculations and not investments. But in each case they have, through the processes of time and experience, so changed in characteristics and have come to be so highly protected by assets and earning power, that they can now only be classified as high grade investments. Of course, this improvement in the quality of these issues has been reflected largely in the increases in the market prices. These increases in price have been due partly to greater intrinsic worth, but even more due to increased dividend returns. A stock like General Electric, selling at a high premium nowadays, shows a very satisfactory return on the money to the investor and offers the added inducement that still larger dividends may be paid in the future.

The above are types of the premier industrial common stock investments. Following these are

many degrees of desirability or undesirability. Hundreds of issues could be named which are more in the investment than in the speculative class. Many such are at times unusual bargains for the discriminating buyer. Of course, as in the case of practically all securities except those of the very highest grades, industrial stocks fluctuate in price in accordance with changing business conditions. A stock like United States Steel common, for example, may decline twenty-five points in a year of depression and rise fully as much or more in a year of prosperity. And yet, its intrinsic or asset value may all the time be steadily increasing.

It must be emphasized, therefore, that the problem of investing money in all industrial common stocks, in many preferred issues, and in some bonds makes it necessary that the investor give unusual attention to the broad fundamental factors, such as the general business cycle, the effects of political changes, the ebb and flow of trade and of prosperity or depression. More than any other class, industrial securities reflect the trend of business conditions. While, consequently, a man may safely select industrial securities at any time for the purpose of placing his money safely at work at a definite return, yet he is offered unusual opportunities for buying just such issues on a favorable level and at bargain prices, provided he gives full and proper attention to the general factors mentioned.

In a later chapter I shall elaborate the advantages of an investment policy which gives proper weight to the influences of the business cycle and will show how important this side of the question is for every investor in industrial securities.

Chapter IX

SELECTING PUBLIC SECURITIES

THE term "public securities" embraces what are more clumsily designated as "government and municipal obligations." This includes all public debts, in any form, of nations, states, counties, cities, towns and villages or other civil divisions.

One of the most outstanding facts of modern civilization has been the tremendous expansion in the creation of civil obligations of one sort or another. To the average observer not familiar with general finance, the increase in government debts, brought about during the last ten years as a result of the great war, appears to account for most of the growth in public indebtedness. But this is only partially true. During the same period of ten years, during which the civilized world has been plunging into war debts, steady expansion has taken place in the outstanding obligations of all minor civil divisions throughout the United States and in all the other important countries of the world. At the present writing, the aggregate indebtedness of states, counties, municipalities, and other civil divisions in the United States alone is estimated to be in excess

of ten billions of dollars, as compared with less than a third of this amount only twenty years ago.

The growth in the number and amount of municipal debts has logically kept pace with the growth of the country in wealth and population, and with the constant development of modern methods for maintaining and improving the general standard of living of the people. New needs are constantly demanding new expenditures in all sections of the country. For instance, the introduction and general use of the automobile have created an insistent demand for good roads in every state. Roads cannot be built without the expenditure of money, and this money, for the most part, can only be obtained by the creation of bond issues by the states, counties, cities and towns. This one development, therefore, has had considerable to do with the expansion in volume of public obligations during the past decade.

Moreover, the tendency of the times has everywhere been in the direction of introducing improvements and modernizing public property in the towns, cities, and rural districts. There has been an insistent demand, with increasing wealth in the United States, for better public buildings, better schools, better water supply and sewerage systems, better pavements, more and better parks and playgrounds. These things have made it necessary for municipalities to spend far more money than ever before

and consequently have been a great force in the tendency toward increasing public debts.

This rapid expansion of the obligations of cities, towns, and counties has sometimes been wasteful and extravagant. In these days of high cost of living and heavy taxes, the capitalist and the investor persistently turn, so far as possible, to quarters where the tax burden may be lightened. Under the laws of the states and of the nation, municipal obligations of all kinds, unless specifically excepted, are entirely exempt from all taxation. Consequently, even in its days of greatest need during the war, the Federal government could not levy taxes on the obligations of states or their subdivisions, nor on the national debt which had already been created.

The abnormal situation which developed during the war years, therefore, naturally served greatly to broaden the market for the sale of municipal securities. This acted as an incentive for municipalities in general to spend money rapidly in all sorts of improvements.

Another factor which has recently tended to increase municipal debts has been the generally inflated condition of all values, including land values, as compared with earlier days. The limit to the debts of municipalities is based, for the most part, on the assessed valuations of all property embraced in the particular community. As these valuations have risen there has naturally been an equal ex-

pansion in debt limits and this has opened up the possibility for greatly increased issues of bonds.

To study municipal or government obligations from the investment standpoint, one necessarily employs quite different methods than would be the case in analyzing corporation securities of any kind. Municipal bonds are not mortgages; they are not dependent for their strength on earning power or operating results; and their position does not depend, as in the case of corporation securities, on the effects of competition or the condition of markets.

But municipal securities have a bulwark of strength in the fact that they are, in effect, a direct and first lien on the entire wealth and resources of every community except in cases where there is some specified restriction. In brief, they are protected by the taxing power of the state. The state or civil division is the supreme power in its particular locality, and taxes are always a first charge against all the citizens of a community and all the taxable property in that community. Consequently the municipal obligation receives its strength directly from society, as taxes, being a first lien, must be paid before anything else is paid. If a tax on real property is not paid, the municipality or state can sell the property at auction for the purpose of collecting the unpaid taxes.

This is the outstanding fact to be remembered by every one who contemplates investing in public se-

curities. Starting from this fact, the proper method in the selection of different issues is to examine the general characteristics of the community, its location, its percentage of population growth and present population, the types of industry which give it its permanence and stability, the general character of its people, the past and present records of municipal administration, the assessed valuation of all property, the value of property directly owned by the municipality, the tax rates levied in the past and at present, and the general trend of the tax rate. Every municipality is required to make an annual financial statement, and such statements should always be secured and examined by the man who contemplates loaning his money to the municipality.

Having carefully considered all the points outlined above, further investigation should be made as to the particular characteristics of the bond itself. Municipal securities are not all alike. They are issued for many purposes and many of them carry special qualifications or limitations which affect their position in the general debt of the community. There are, for example, many issues of municipal water bonds. These are obligations created for the purpose of building, extending, or operating water supply systems. Other bonds are specifically issued for schools, for parks, for public buildings, for paving streets, for construction of docks, for dredging

of rivers, for fire department service, as well as to meet the costs of general administration. It is often the case that municipal bonds are issued for certain specific purposes, and their general claim on the taxable revenue of the municipality may be specified or limited. It may be that the bond is issued for some directly productive purpose, such as the supplying of water, and the revenue from this particular service may be allotted to the credit of the bondholders. On the other hand, bonds may be issued frankly for the purpose of covering expenses of political administration, with no special protection. Consequently, there is frequently a variation in the investment quality of different bond issues of the same community.

The municipal bond which has no special protection and is a simple obligation of a community should always be what is known as a serial bond, or a bond protected by an active and substantial sinking fund. In the great majority of cases this plan is followed. The virtue of the serial plan or of the sinking fund lies in the fact that the principal of the bond is currently taken care of by tax revenues from year to year, and, while new obligations may be issued in its place, the investor continues to receive his principal or get added protection as the bond issue is being paid off.

Although all municipal bonds carry certain similar general characteristics, there is great variation

in the market prices of such obligations, and some are infinitely better investments than others. The primary differences are generally tied up with the characteristics of the community itself and its geographical location. The obligations of great cities like New York, Philadelphia, Boston, or Chicago are necessarily on a stronger plane than the obligations of small cities. Those of small cities are generally better than those of villages or towns. Those of villages or towns are often more desirable than those of counties or rural districts.

The same sort of differentiation is found when it comes to the question of locality. The typical municipal obligation of an average municipality in the states of New York or Massachusetts is obviously better, where most other things are equal, than the obligations of smaller communities in many of the Southern or Western states. The obligation of a town or city located in a prosperous section where a tendency towards population growth and of wealth increase are apparent, is more desirable than the obligation of a town or city of equal size in a stagnant section, or in a location where prosperity depends directly on one or a few types of industry.

For the most part the markets for municipal bonds are among institutions such as savings banks and insurance companies, trustees of estates, and firms or individual investors whose incomes are substantial or who are directly interested in curtailing their

tax burden as much as possible. The small investor whose income taxes are nominal need not ordinarily invest any great proportion of his funds in public securities. In fact, it will be, especially in modern times, a difficult task for him to find sound municipal bonds which show him as liberal a yield as he can get in high grade, well protected corporation securities. To find attractive yields, such investors must turn to the type of public obligations which in these times are practically on a par, in the matter of taxability, with most corporation bonds themselves. That is, he must go outside of his own country and buy the municipal obligations of other countries. But when he does this he must abandon the motive which may actuate him to buy municipal issues; that is, to get the benefit from the tax-exempt features. For while most foreign governments and municipal obligations are exempt from taxes in their respective countries, they are all subject to taxation in America on practically the same basis as corporation bonds.

The government bond investment field in this country has assumed great importance in recent years because of the large increase in the debt of the United States. The great Liberty loans created during the war and the short term obligations subsequently issued are distributed in the hands of millions of investors, large and small. Liberty Bonds are undoubtedly the highest type of important pub-

lic obligations in the world to-day, but instead of being in the class of tax-exempt securities, most of the Liberty issues, as a result of special war legislation, are subject to taxation. The only fully exempt Liberty issue is the First Liberty loan, created in 1917. The other issues, while carrying some qualified tax-exempt features, are, for the most part, subject to the same type of income taxation as corporation bonds, except to holders of very small amounts.

It is unnecessary, of course, to go deeply into the problem of examining the security of United States Government obligations. They are all secure and undoubtedly always will be secure. The only problem for the investor in Liberty Bonds is to determine for himself the question of market price and whether it is wise for him to buy or sell them at a given time. While for some time after the close of the war the Liberty issues sold at heavy discounts, they now are all quoted at premiums. These vast loans have long ago been fully absorbed by the investing public, and the retirement policies of the government are steadily reducing the available supply. It is quite possible that none of the $4\frac{1}{4}$ per cent. issues will ever again be quoted at a discount.

For the investor of substantial capital who wishes to follow a policy of proper diversification, a reasonable proportion of American public securities should be favorably considered. He must, of course, if he

follows a conservative policy of selection, be satisfied with a moderate return on his money and must not ordinarily give much weight to the question of possible profit. Except in the field of weak or speculative municipal bonds, the market prices of the issues are governed almost wholly by general money market conditions and the general trend of interest rates. In times of tight money, most municipal obligations will tend to decline in price just as other high grade bonds do, and they will rise in times of plentiful money supply. But the swing of prices for municipal bonds will generally be found to be less than in the field of typical corporation bonds of the various classes.

If an investor contemplates placing a substantial amount of money in American municipals, he should, on general principles, diversify it not only geographically and on the basis of population, but also into different types of issues. It is well to include, in any large list, some bonds of the short term type, some of the serial type, and some of longer maturity. It is well to select obligations of several of the larger cities, of states or towns located in different parts of the country, and also to include at least a moderate amount of United States Government obligations.

Every investor, of course, must determine for himself just what proportion of his capital he is willing to tie up in premier securities which, under

any conditions, will not be exceptionally lucrative from the revenue point of view. *But for every man who invests money there is no principle so sound as that of placing at least a portion of his capital in a place of absolute security.* After all, it must never be forgotten that security of principal far transcends satisfactory income return.

In connection with the issuing of public securities there has developed in this country during the last few years, a great deal of agitation in favor of abolishing the tax-exemption feature. This question has been brought to the front because of the high income taxes which prevail nowadays. As already pointed out, the tendency of the average large investor is to seek securities which are exempt from taxation and thus pay less of his income to the government. It has been estimated that several hundred million dollars a year is lost in possible tax collection because of the existence of the exemption feature. Further, the tax-exemption feature has made it so easy for the average municipality to sell its bonds at high prices that extravagance and wastefulness have been stimulated.

A bill has been introduced in Congress favoring a constitutional amendment which would eliminate the tax-exempt feature. All of the political parties have been endorsing this program, but up to the present writing it appears evident that the chances of a constitutional amendment of this kind passing,

are remote. As time goes on and the national income tax rates are further reduced, the chance for a constitutional amendment becomes steadily poorer. It would, of course, be a constructive change and would undoubtedly be more beneficial than harmful to the country as a whole. But the likelihood of a change in the near future is so remote that it need not be taken seriously into consideration by the average investor.

Of course, in the event of a constitutional change of this kind, the character of the municipal bond market would tend to change also. Municipal bonds would not be so distinctly in a class by themselves as they are to-day, for they would come into competition much more directly, in the investment markets, with corporation obligations than they now do.

In addition to the types of public securities which I have been discussing, there are in existence certain obligations which might be classed as semi-public in their characteristics. For example, the various obligations issued by the Federal Farm Loan Board and the Federal Joint Stock Land Banks are in this class. While they are not directly guaranteed by the Federal Government, they have in effect, practically the same protection as government issues. The laws are so framed that the dangers of default are reduced to a minimum and only an extraordinary situation would put any of these issues in a doubtful position. Further than this, the Su-

preme Court has decided that all the obligations of the Farm Loan Board and of the Joint Stock Land Banks are fully exempt from Federal taxation. This exemption has made them appeal to that large class of the investing public who are interested in curtailing their tax burdens. While it cannot be said that Farm Loan or Joint Stock Land Bank bonds are to be classed with direct government obligations, such as Liberty Bonds, yet they all stand on a high investment plane.

In modern times, with the expansion of the United States outside of the continent, there have come into existence a number of obligations of American dependencies. These bonds are, of course, to be classed as public securities. For the most part they are protected with the guarantee, assumed or implied, of the United States Government. Certain of these colonial issues yield substantially higher average income returns than do many municipal bonds of less desirability and in most cases they have equally broad markets.

Chapter X

SELECTING FOREIGN INVESTMENTS

PRIOR to the World War the interest of American investors in foreign securities of any kind was very limited indeed. It is true that for many years a substantial amount of American capital had been invested in Canadian securities, both public issues and corporation issues. The outstanding American interest in Canadian corporate undertakings was in the securities of the Canadian Pacific Railway Company. For many years the stock of this company had been a popular American investment. Furthermore, an ever increasing amount of American capital was every year going into other enterprises in the Dominion of Canada and just before the opening of the war interest was growing rapidly in the municipal and provincial obligations of Canada.

Aside from this Canadian interest, the only other important foreign country in which Americans had extensively invested was Mexico. For many years American capital had been quite steadily flowing into that country, and by 1913 it was estimated that several hundred million dollars of American capital

had become tied up in Mexico either through the ownership of Mexican Government bonds or in connection with the development of the railroads and the oil and mining industries. Beyond these instances, however, the amount of American capital permanently placed in foreign countries was of comparatively small importance.

The events brought about by the war have, of course, radically changed this situation as they have changed the financial condition of practically every country in the world. To-day it can be safely stated that American capital in vast amounts is more or less permanently invested in all civilized countries. Not only have billions of American dollars gone into Europe, but enormous sums are now invested in South and Central America, in Japan and in most of the British Colonies in addition to Canada. Moreover, the amount of American capital now invested in Canada is probably ten-fold what it was in 1913.

It will consequently be seen that the subject of foreign investments has become a very important matter for Americans in general. The billions of dollars which are now invested abroad have come from tens of thousands of individual American investors as well as from a very large number of banks, financial institutions and other organizations. This vast foreign investment cannot be looked upon as in any sense temporary. American capital has gone abroad permanently and it is obvious to any student

of the subject that during the coming years a steadily increasing amount of American funds will seek foreign investment.

It is roughly estimated to-day that, aside from the sums represented by the so-called Inter-allied debts, there are perhaps ten billions of dollars of American capital or credits invested permanently or temporarily in foreign lands. The best judges of the present situation predict that this amount is likely to be doubled within the next decade.

To approach the study of foreign investments one must begin by classifying them into several different types. To begin with, there are the obligations of governments, municipalities and other civil divisions. Then there are the obligations of foreign railroads, industrial corporations and other enterprises. These foreign obligations are classified into two distinct types — external loans and internal loans. There is a great fundamental difference between the two. An external loan is an obligation of a government or other civil division or perhaps of a corporation which is issued, usually, in the monetary denomination of the foreign country in which the bonds are sold. In brief, it represents money borrowed outside the borders of a given country. Consequently the funds secured by external loans always come from the people of some other nation.

Internal loans, on the other hand, are obligations

of governments or corporations which represent borrowings from their own people. The funds raised by an internal loan are supposed to be provided by the country itself and, of course, the settlement of such loans is made directly at home with the citizens of the country.

The settlement of external loans, however, is a matter which is always far more complicated. Both interest and principal on such loans must be exported to the country in which such loans are sold. This affects the foreign exchange situation, the balance of trade figures, and has a very direct influence on the position and standing of the country as a whole. Thus from the standpoint of the nation itself, it is always much better for the government to raise its funds internally rather than externally. And prior to the war practically every country of great wealth and stability raised its funds by the flotation of loans among its own citizens. It was only in the case of the newer or smaller countries where capital was scarce and where outside funds were urgently needed, that there existed any great amount of foreign debts.

The outstanding instances of heavy foreign debts before the war were, of course, mainly the large South American Republics such as Argentina, Brazil and Chile. These nations had always found it necessary to seek heavy sums of capital abroad for the general development of their countries.

But the older nations of Europe, as well as the United States, had no external debts worth mentioning prior to 1914. For many years Great Britain, France, Germany, Italy and the Scandinavian countries had all found it a very simple matter to finance their own needs practically without any outside borrowings.

As the records show, prior to 1914 most of these countries were able to borrow money from their own citizens at very low rates of interest, averaging something like $2\frac{1}{2}$ per cent. to 3 per cent. Indeed, Great Britain thirty years ago was able to borrow immense sums in London on long term obligations at as low a rate as 2 per cent., and in 1913 she did not have to pay very much more. In 1912 and 1913 France, Germany, Holland, Denmark and the larger municipalities in these countries, were all able to finance themselves at what now appear to be extremely low interest rates.

But within the past decade the picture has, of course, radically changed. The war forced all of these European nations to seek capital and credit outside their borders and as the conflict went on and their needs became more urgent, more and larger external loans were floated. Germany and Austria were the only large nations which found it difficult to secure any amount of outside capital. Great Britain, France, Italy and the neutral nations of Europe all went into the foreign markets and increased

their external debts with great rapidity. These debts were necessarily still further increased during the five years following the close of the war, so that to-day the external obligations of almost every country in Europe amount to enormous sums and have completely changed the financial bases on which these nations exist.

The events brought about by the war also changed the status of South American countries and other nations which were not directly involved in the conflict. For generations South America had sought capital from Europe, but the war naturally cut this source of supply off very sharply. Thus was the South American market opened for the United States and the bulk of the South American external financing during the war and since the war, has been done in the United States. Consequently we find to-day that the American investing public, instead of having perhaps 99 per cent. of its investment capital tied up in domestic enterprises and obligations, is to-day interested to the extent of fabulous sums in the affairs of most other nations.

And this American interest is not confined to external government obligations alone. The needs of business men and of producing organizations in Europe and other countries have had to be met by outside capital to a considerable extent and consequently to-day a very large number of private corporations are obligated to American investing inter-

ests. Moreover, a substantial number of Americans have, during the war and since the war, placed funds in the internal obligations of other countries. The motive for doing this has, of course, been primarily speculative and in many instances has ended disastrously. But nevertheless at the present time very substantial sums are tied up in internal bond issues of European and other foreign governments and in European producing enterprises in general.

The fact should be emphasized that an investment in an external bond of a foreign country is almost invariably a better investment than an internal bond. Practically all of the external issues which have been sold to Americans are what are known as dollar bonds. That is, they are issued in the terms of United States currency and both principal and interest are payable in gold at some American agency. As an illustration let us take the 8 per cent. external bonds of the French Republic which were sold in this country in 1920. These bonds are a full external obligation of the French Government. Both principal and interest, as well as sinking fund, are payable in New York in United States gold coin and the French Government agrees to have the necessary funds in the hands of J. P. Morgan & Company in New York for fully meeting the obligation as it falls due. This makes it, in effect, an American loan, and the market value of the bonds being expressed in dollars, it is not affected

directly by fluctuations in the value of the French currency.

On the other hand, a French internal loan, which is expressed in French francs, fluctuates in value, from the American standpoint, with the changes in the dollar price of French francs. To the Frenchman who thinks in francs and who measures all things in francs, the French internal loan may appear to remain at about the same price. And so far as he is concerned, it makes slight difference to him what price the bonds are quoted at in dollars. The cost of living in France is measured in francs, and, of course, fluctuates with the changing value of the franc. But if the franc is fairly well stabilized around a given value as it has recently been, the price of his internal bond, in terms of francs, will not fluctuate very much. Any change in price will be mainly due to demand and supply, to the current interest rate and to the general credit trend of the government itself.

It will be seen, consequently, that while an internal bond might prove a satisfactory investment in France for her own people, the situation is radically different when looked at from the standpoint of an outsider such as an American. In these days the American who buys French internal bonds is, of course, practically speculating in French francs. On the other hand, if he buys an external French bond, he is not speculating in francs but is simply

loaning money on a dollar obligation of a government which he believes is strong enough easily to take care of that obligation.

This situation applies all along the line and while there are many internal obligations of many nations which can be classified as high grade investments from the American standpoint, this is not to-day so true of the internal issues of the war-ridden nations of Europe nor of any new or weaker nations like most of the South American Republics or the Far Eastern countries. Such issues are almost always more of a speculation than an investment.

Of course, when we turn to the internal loans of a powerful nation like Great Britain, we must agree at once that they are practically all in the investment class and this is also true of most of the governmental or provincial obligations of the Dominion of Canada. While for a time British credit was seriously injured by the events of the war, Great Britain has now recovered her financial position and largely restored her strength. Thus we see that British governmental issues are to-day quoted in the London market at high and improving figures and are likely so to continue.

Of course, the situation with nations like France, Belgium and Italy is not nearly so favorable. These countries were obliged to inflate their currencies heavily during and after the war and did not follow nearly so farseeing and wise a financial policy as did

Great Britain. The French franc is to-day worth only about 25 per cent. of its pre-war value, as measured by the dollar, while the Italian lira is worth only about 20 per cent. of its pre-war value. Whether these currencies will ever be restored to their old gold values is a grave question. It is more likely that there will be a devaluation in time and that the par values of these currencies will be placed at lower figures. Of course, if this happens the internal debts of these countries would also be equally deflated as measured in the American dollar.

Because of the uncertainties of the currency situation in so many foreign countries, it is by all means better for American investors to confine themselves mainly to the purchase of external bond issues of these countries. For by investing in external bonds they are not taking any chances regarding the future banking policy of the nations themselves. They are buying into a foreign loan which is certain, if the world is to go on at all, to be taken care of in preference to internal debts.

The history of the civilized world for the past two hundred years demonstrates the fact that external obligations of all countries of genuine stability have always been considered prior charges against revenues and have always been taken care of. This, of course, has not applied to all new countries or to those of lower grade civilization. But it has applied to the nations of the world where a reasonably high

standard of intelligence and education have prevailed.

The situation has been natural enough. No nation of importance can maintain its standing and credit with other nations and progress unless it takes care of its foreign debts. Consequently, meeting foreign obligations is always the first thought of statesmen in every land. Where this is not done, no progress can be made in restoring foreign trade or building up credit. An outstanding example in these days is that of Mexico. Mexico defaulted during her last revolutionary period on all of her foreign debts, but her first move, when her government was recently reorganized, was to work out plans for taking care of foreign obligations, for it is only in this way that she can regain her standing with the world, carry on trade and secure a renewal of credit. And thus we see at the present time the greatest problem in connection with the regeneration of Russia is the question of her reassuming her foreign debts and providing ways and means for meeting them during the future years.

It is important to emphasize certain of the primary factors to be borne in mind in investing money in foreign securities. I think that every investor should give preference, in the great majority of cases, to external rather than internal debts. He should then carefully consider the question as to whether the country issuing the obligation is obvi-

ously strong enough to take care of it regardless of unexpected events. All external bonds are not equally good; they vary in quality like any other bonds, and, of course, they vary greatly in income yield and general desirability. In these days foreign obligations, especially those of Europe, respond pretty directly in price to special influences which would not obtain in more normal times.

The market for most foreign bonds in the United States has developed primarily among the group of investors who are attracted by a large income return and are generally willing to take certain chances which the more conservative investor would not consider. Very large sums of American capital have been invested in foreign bonds by speculators or semi-speculators. Yields of 8 per cent. or 10 per cent. appeal strongly to such people, as do the broad fluctuations in market prices. During the past five years there have undoubtedly been large sums made as well as lost by people who have bought and sold European external bonds.

At the present time, however, while the speculative element in this field is still an outstanding characteristic, foreign issues as a whole are slowly becoming more stabilized and consequently the speculative opportunities are not so great as they were. The general rehabilitation of Europe is undoubtedly progressing and with the final settlement of the reparation tangle, the chances strongly favor a steady re-

covery in all parts of the European Continent. The condition of the masses of the people, their standard of living and general stability, are, of course, the most important fundamental factors with any nation. If improvement is going on and if the prospects for peace and stability are good, the credit of that nation is certain to be maintained or to improve.

At the present time, in view of all the circumstances, it appears safe to express the opinion that during the coming ten years at least there will develop a further general improvement in European credit. As producing activities and wealth creation increase, foreign nations will more and more be able to eliminate inflation and restore their credit. This tendency is bound to be reflected by better and more stabilized markets for foreign bond issues.

While in recent years it was necessary for outstanding nations in Europe to pay 7 per cent. or 8 per cent. for American capital, the prospects are that during the coming few years the rate necessary will hover more closely around 6 per cent. Five to ten years hence, many of these high interest-bearing foreign loans may be refunded around 5 per cent. and the countries of best credit will again be able, as before the war, to borrow money at low interest rates and an increasing amount of it will come from their own citizens.

If this forecast is sound, it is obvious that good

foreign external loans are attractive things for the typical American investor to place at least a portion of his funds in. No investor should put all his eggs in one basket and no investor should put all his capital into foreign loans. But careful selection of the best issues is to be strongly recommended. The highest grade European issues, outside of Great Britain, are, at present, the obligations of countries like Switzerland, Sweden, Denmark, Holland and Norway. The French and Belgian issues are, of course, better than those of countries like Austria or Hungary, and, for the most part, much better than external obligations of some of the South American Republics. It is a mistake to assume that an external bond of a government like Czechoslovakia is poor merely because the currency of that country is heavily deflated. The external bonds of that country are strongly protected and under even the most adverse conditions would undoubtedly be taken care of.

One fact which the American investor in these European loans should not overlook is that the market prices in these abnormal times do not necessarily reflect the real security of the loan. Because of the general world unsettlement and also because of the profound ignorance of many Americans regarding Europe, many of these bond issues have widely fluctuated in price as a result of rumor, propaganda and fear. There has never been any logical and sound

reason, for example, why the City of Prague 7½s should have sold at the absurd price of 67, and yet in 1923 they could be bought at this figure for a long period. There has never been any logical reason to think that the French and Belgian external bonds are not good. The intelligent investor who studied the facts before he bought these bonds, would have been foolish to sell them at the absurdly low prices of 1923, just as the man who subscribed for Liberty Bonds at par in 1918 was very foolish to sell them out when they dropped to 85 in 1920.

Chapter XI

"MISCELLANEOUS" INVESTMENTS

ASIDE from the various groups of investment issues which we have been discussing in previous chapters, there are certain types of securities which cannot be classified in the ordinary way. As already pointed out, the great groups of security investments in America are generally classified into railroads, public utilities, industrials, and government and municipal issues. In recent years, a new and important group which has become of great interest to Americans embraces the various types of foreign obligations.

But in addition to these several groups, there are various obligations which defy specific classification. Such issues go under the general name of "miscellaneous" securities. This "miscellaneous" group includes a substantial number of investment obligations, both bonds and stocks, which have come to the front in recent years and undoubtedly represent a substantial amount of permanently invested funds. I will give brief consideration to the most important of these in this chapter.

With the rapid increase in the size of American cities and the great growth of wealth production,

there has necessarily been a steady expansion in building construction and in real estate development in general. Within a generation we have witnessed the practical rebuilding of towns and cities by the replacement of old-fashioned buildings with new, by the construction of modern types of dwellings and apartment houses and by a very rapid expansion in the size and types of office buildings, manufacturing plants and all other business buildings.

The rapid increase in land values and the general inflation in commodity prices, which developed rapidly during the war years and has been pretty fully maintained since, has made necessary the investment of great sums of money in construction of every type. Coincident with this great movement has gone hand in hand a speculative movement in real estate. At the present time rents in almost every section of the United States are double or more than double those of ten or fifteen years ago; the site values and land values in towns and cities have doubled or more than doubled; the costs of labor and of building materials have equally increased. As a result of all this, it has been necessary to seek far greater amounts of investment capital to be placed in construction and real estate fields than ever before.

Thus we see that in the investment field practically a new department has grown up — that of seeking capital among individual investors for

financing real estate undertakings. This development has, for the most part, taken the form of organizations or companies who distribute to individual investors mortgage bond issues secured more or less directly on buildings and realty of practically every type. Such bond issues have been advertised broadly and sold, for the most part, in small denominations to the small investors of the country. In most cases these bonds issues have offered very high rates of interest as compared to the old-fashioned real estate loan.

This real estate bond selling business has spread so far throughout the country and has apparently proved so lucrative to a large number of concerns that great speculative dangers have developed along with it. It is exceedingly difficult for the typical investor to pick and choose between one or another of these many realty issues. Undoubtedly a great many of them are high grade attractive investments, but unfortunately a great many others are obviously speculative and dangerous.

Without going into details regarding the merits of specific real estate issues, one can, I think, get a pretty fair idea of their relative merit by bearing in mind certain fundamental facts which apply to real estate mortgages in general.

In a large city like New York, it is a well known fact, proved by long experience, that a genuine investment of high grade in improved real estate

cannot be expected to yield a very high interest rate. Of course, in these days yields average higher than they did ten or fifteen years ago. But nevertheless, a genuinely secured real estate mortgage is ordinarily not expected to yield much more than 5 per cent. and certainly never more than 6 per cent. on the money invested. The best real estate mortgages on improved property in cities like New York, which are generally held by institutions such as insurance companies and banks and wealthy investors, in many cases are floated on a 5 per cent. or 5½ per cent. basis even in these days.

While there are exceptions, an investor should be skeptical when he is told that a 6½ per cent. or 7 per cent. or 7½ per cent. first mortgage bond, secured on some parcel of improved real estate in a city like New York, is a strong investment. In nine cases out of ten it is nothing of the kind; it is a mere speculation and probably a dangerous one at that. Of course, there are concerns who in offering such bonds furnish appraisal figures and other statistics which appear to bear out their contentions. But almost invariably in such cases it will be found that there is something unsound or wrong about their figures and that the situation is speculative in some form or other.

I have always held the view that if a man wants high interest and wants to take speculative chances, he had much better buy securities which have broad and active markets and can be turned into cash on

a moment's notice, rather than put his money into bonds or other obligations for which there is little or no market.

The business of selling real estate bonds of small denominations to investors has become so widespread that a note of warning is necessary. We should not condemn the type of issue but we should always question its quality before investing. The great majority of this type of bond being offered nowadays is not good enough for the average investor. Only a small minority are to be strongly recommended.

A type of investment which appeals to an entirely different class is the stock issues of banks, trust companies, insurance companies and other financial institutions. For many years bank stocks in the United States have been a popular form of investment, but ordinarily, of course, have appealed only to the man of substantial wealth. A bank stock is either very good or very poor. Bank stocks have never come into the ordinary speculative markets of the country and, because of their very nature, have seldom been subject to any speculative manipulation. Consequently the type of people who are seeking opportunities to trade in securities and make quick profits or secure large yields, have not usually been attracted to the stock issue of a bank or other financial institution. While the capital stock issues of some banks are widely distributed among many

investors, this is not universally the case. It will be found for the most part that bank stocks, especially those of large institutions in the big cities, are held largely by wealthy investors who often own them in very substantial blocks.

But, as a matter of fact, experience has shown that during the last twenty years bank stocks have often proven one of the very best types of investments. This has been especially true in the case of institutions which have grown steadily with increasing population in their territory and have fortunately had the benefit of efficient or superior management.

The history of banks and trust companies in the city of New York, for example, during the past fifteen years, fully demonstrates the fact that the bank stockholder has had few opportunities to make mistakes and often has enjoyed a very lucrative income. The steady growth of the banking business, the unceasing increase of wealth production, naturally are reflected by a growth of business for well conducted banks. In modern times an increasing percentage of the American people have learned to make use of banking facilities. The banking machinery of the United States is far more highly developed than that of any other country in the world, and the functions of the banks, trust companies and other financial institutions have become steadily more vital and important as time has gone on.

One can look back thirty years and find that at that time the largest bank in New York City had less than $100,000,000 of resources. Nowadays we have New York City banks with resources of from $500,000,000 to over a billion dollars. Deposits of $10,000,000 were looked upon as heavy for a New York bank in 1890. Nowadays many institutions have from $300,000,000 deposits up to much higher figures.

This record of growth is duplicated, in more or less degree, by the banks of all the cities and important towns of the United States. The city banks in every state in the Union have presented a record of growth and, for the most part, of great stability which demonstrates their general permanency and soundness.

In selecting bank investments one should, of course, follow certain common sense principles which are easily pointed out. While there are more than 35,000 banking institutions in the United States, it must be remembered that the great majority of these are small country banks, many of little or no importance and a good many, in certain sections of the country, of very little financial strength. But out of the total banking institutions of the country there are at least several thousand which have demonstrated their strength and stability and have proved permanently profitable businesses for their owners.

Naturally, in the matter of selection one should give preference to the institution located in a growing city or a growing or healthy section. He should give proper attention to the past record, age and present management of the institution. He should give thought to its type of business, whether it is a purely commercial bank or has more speculative characteristics. He should give proper weight to the personnel of the management and should naturally study and analyze the bank's financial statements.

The market price of bank stocks, of course, is governed generally by two factors: first, the book value of the shares as shown by the bank's statements from time to time; second, rate of dividends paid or likely to be paid. All national banks are, of course operated under Federal laws which go far to protect the stockholder from the dangers of bad management. State institutions in some sections of the country have the benefit of much greater protection and proper regulation than in others. Consequently the investor should give proper thought to these factors. While the days of the famous "wildcat" banking of the country are over, at the same time there are still, in some sections of the United States, to be found wildcat institutions which call themselves banks.

There are a group of modern investment issues which, while ordinarily classed as industrials, have

distinctive characteristics of their own and should be relegated to a group by themselves. These are the obligations of mining companies such as coal mines, copper mines and gold or silver mines. The great majority of security issues in these fields of industry is represented by stocks and carry a strong speculative tinge.

The average man who is willing to place money in a pioneering enterprise like a mine, with all the risks which are necessarily involved, is generally more of a speculator than an investor and the vast majority of security issues created in these fields are speculative securities which can seldom be favorably considered as any form of investment.

At the same time there are some issues of great intrinsic worth, earning power, and of genuine stability which can be strongly recommended in all of these fields. In recent years many of the larger copper producers have created bond obligations, while coal mining and coal producing companies have for years issued bonds in one form or another. Such bond issues, in order to be sound at all, must necessarily be directly secured by mortgage on property of demonstrated worth and not merely on current or past prospects for earning power or future possibilities or hopes. And a bond issue of a mining company of any kind should also have unusual and special protection in the matter of sinking funds. Any kind of a mine, whether it be copper, coal, gold,

silver or anything else, is, of course, subject to ultimate exhaustion. Every dollar's worth of ore taken out of a mine reduces its value to just that extent; therefore, as its value is reduced, its liabilities, whatever they may be, should be equally curtailed.

The investor who is contemplating placing money in obligations of this type should, of course, apply the general principles of analysis which are necessary in studying all securities. But he should lay special emphasis on the question of permanent prosperity and earning power for the concern, and he should see that a proper amount of the revenues or earnings are regularly set aside to take care of his principal prior to maturity.

As a matter of fact, this factor of possible exhaustion should be given special consideration also by stock investors in such enterprises. It is all very well to have it shown that a certain gold or copper mine has, at a given time, demonstrated ore reserves of a certain amount and has current earning power equal to many times its dividend disbursements. But what might be the case at one time may quickly change to something else.

A mining stock, no matter how high grade it may appear at a given time, may easily become worthless if the property is not closely watched. A shining example of this fact is that of the well known Tonopah Mine of Nevada. Twenty years ago this mine was one of the best producers of gold in the

United States. The company had been lightly capitalized and was paying dividends of 100 per cent. or more on its capital stock. The stock had a par value of $1, but was selling in the market for $15 to $20 a share. At this price it showed a liberal dividend yield and many people assumed that it would always be worth as much as this, if not more. But as production went on, the ore reserves were being exhausted and in the course of ten or fifteen years there was little high grade ore left. Consequently the price of the stock commenced to decline, its dividends began to be reduced and those who had bought it for investment purposes years before lost the bulk of their principal.

The same result has been experienced by many holders of mining company bonds. There have been bond issues outstanding which at one time looked very strong and in view of the enormous earning power of the companies seemed certain to remain always good. But long before the maturity of the issues the property had been largely exhausted or the grade of its ore had fallen and costs risen to such a point that no money could be made. Consequently, in such cases, the investment became a complete loss.

Coal mining bonds, as a general proposition, have turned out to be better investments than most of the others. There are in the markets to-day a substantial number of such issues which are unde-

niably high grade and will probably always remain good.

Issues of this type should generally be placed in a group by themselves, as they are different from the ordinary class of industrials because of the fact that the prosperity of the companies is so directly dependent on a continued supply of the natural resources which they dig out of the earth. A manufacturing or trading company is not necessarily in this position at all. It may depend upon a continuous supply of natural resources of crude materials, but its real money is made in the manufacture or production of commodities, and its raw materials need not necessarily come from one mine or one section.

Chapter XII

INVESTMENT CYCLES

A STUDY of investment cycles, treated from the standpoint of the investor in bonds and stocks, simply resolves itself down to the question of when to buy and when to sell securities. Many people assume that this question is only of primary importance to the person who wishes to speculate and try to take advantage of rising and falling markets, rather than to invest his money safely and profitably.

But, as a matter of fact, it is extremely important for an investor to know when and at what levels to buy securities; it is equally important for him to know when and at what relative levels it would sometimes be wise for him to dispose of securities.

The higher grade the security issues are, the less they are affected in price and quality by the business cycle. The highest grade issues almost exclusively respond in market price to changes in one big fundamental factor such as the prevailing interest rate. Other factors affect them slightly, and, of course, general demand and supply always have some influence. But the rise and fall in the price of

money is directly reflected in the price of such securities.

To be a little more concrete, I would point out that the vast majority of bond obligations which are placed in the highest grade investment class and which carry Moody's *Aaa* rating, are the issues which fluctuate the least in price. It is only during extraordinary periods, such as we have had during the past ten years, that the price swing in such securities is at all wide. Take for illustration a high grade bond like British Consols. For twenty years before the war these bonds had little day-to-day or month-to-month fluctuation. They remained at a comparative level for long periods and only tended downward over a stretch of twenty years or more. During this twenty-year period the world's interest rate was slowly rising and these bonds slowly declined. In some other period when the world's interest rate remained stable, these bonds would have remained practically stable also.

It is when one gets into the field of somewhat lower grade investments that there is a more direct and important response to changing business or economic conditions. The lower one goes down in the grade of investments, therefore, the more vital is the importance of studying the business cycle.

It is unnecessary to emphasize the fact that in modern times business does work in cycles. We have our period of prosperity which is followed by

over-expansion and speculation; we have our period of reaction, decline, and depression which is again followed by a period of revival and of prosperity. This has been the history of all civilized nations during the past century or more. But any careful study of these facts will indicate that these recurring periods are not at all fixed as to either extent or duration. One can follow causes to effects or work back from effects to causes, but no one can very accurately gauge the extent of the effect of a given cause. In practically all cases it is impossible to give due weight to all sorts of cross currents and qualifying factors which either contract or lengthen out or otherwise change the different periods in the business cycle.

The best one can do is to study available facts, base judgment on past experience, and act with intelligent common sense. Fundamental factors of real importance can easily be recognized and their logical effect anticipated to a moderate extent.

To the investor in typical or average securities, one of the primary guides in modern days is the financial or banking condition of the country or nation. In modern times nearly all business of importance is done on credit and by means of banking machinery. When bank deposits are large, when bank loans are relatively low, interest rates are almost certain to be low also, and the funda-

mental condition of business throughout the country is, relatively speaking, on a sound foundation. But business at such a time may not necessarily be active. On the contrary, it may be very dull. But if credit conditions are easy and interest rates low, it generally implies that the financial condition of corporations and big business is sound. It is only in periods when bank loans are heavy and interest rates high or rising, that the typical corporation is over-extended or is carrying excessive liabilities.

We have periods of what is called "over-production." Strictly speaking, they are generally periods of under-consumption. They occur at the end of a time of prosperity or boom, when business men are carried away by success, when commodity prices are rising, and when a large percentage of working capital has been converted into goods awaiting sale. If the demand for goods continued high or further increased, these goods would move out rapidly and the business concerns would not long be over-extended. But when consumption either suddenly or gradually falls off, business organizations are caught with heavy liabilities in the shape of what is known as "frozen assets." Under such conditions, commodity prices decline, goods do not move, and the whole situation becomes distinctly unsound and unhealthy. This was exactly the condition which developed in 1920. Of course, the development of such

a condition brings further evils in its train. It forces failures and therefore tends to destroy credit.

All of these developments are more or less actively reflected in the markets for securities. During the healthy period when prosperity is getting under way and before it has reached the point where over-extension is becoming apparent and the boom is on, typical corporation securities are usually on the upgrade. In the early part of a period of revival the opportunities for successful investment are always the best. Thus the wise investor is the man who buys securities when times are dull, when interest rates are low, when bank loans have not expanded, and when bank deposits are high. If he waits until we are in the midst of the period of prosperity or speculation, he is almost certain to pay higher prices for his investments than at any other time. This applies to all classes of securities, although, as I said above, the effect of these developments on the highest grade issues is always greatly limited.

Conversely, when it comes to the question of the right time to sell investments, the investor will find that the period of prosperity which is approaching its end and working into a speculative boom is the time when he can best dispose of securities. He may have profits, he may have losses, or he may have neither. But if he wishes to take advantage of the investment cycle, he must be courageous

enough to buy when most other people are doubtful and timid, and to sell when all thoughtless people are eager to buy.

Business cycles fluctuate in length as they do in volume and scope. No one has yet discovered any formula whereby the recurring changes in the business cycle can be accurately forecast. There are those who claim to do this but it is altogether impossible. We can, by studying cause and effect, point out what should *logically* be the effect of a given cause or set of causes, but we cannot definitely foresee the full effect of causes, and no one can with certainty "call the turn," so to speak, on an actual change from an upward to a downward trend either in business or in the security market. One can discover after a turn has taken place that it has taken place, and one can guess if one wishes.

There is an old fiction to the effect that the business cycle always runs over twenty-year periods. This idea has been somewhat discredited since 1914, but other types of dogma have taken its place. There are now those who assert that a complete revolution of the cycle occurs every four or five years; others claim that the time is one year or two years. The truth is that no particular length of time necessarily need be embraced in a business cycle.

At the present time it appears evident that the swings from prosperity to depression and vice versa,

are of relatively short duration and of relatively small extent. Since the crash of 1920, which liquidated a large portion of the unhealthy inflation created during the war and after, there has been a noticeable tendency toward moderate fluctuations in the so-called business cycle. This condition may possibly continue for some years into the future. It would seem that with the uncertainty of the times throughout the world and with the great element of caution which has developed in the minds of men everywhere, there is less likelihood or danger of the public being carried away by extreme periods of over-optimism or over-pessimism for many years. For, after all, the business cycle is to a very large extent the result of human psychology. Men still live largely on faith although they are always talking facts. Impulse and emotion govern them fully as much as ever, and most men perform major acts more through intuition than through reason.

To sum this matter up from the standpoint of the investor, the best time to invest, broadly speaking, is always near the end of a period of dullness or depression and at the beginning of the revival rather than later on or earlier. And the time to sell is in the boom or before the end of the boom.

Of course, this is simply a broad generalization. Many exceptions should be applied in specific cases, and the specific factors bearing on different types of

securities and different types of business must be given their full consideration.

It will be realized from what I have said above that a careful consideration of the broad trend of business conditions is vitally important to the investor who wishes intelligently to place his funds at work. To give a concrete illustration, let us consider a normal period such as the ten years prior to the opening of the World War. A person who had carefully studied all the evidence would have realized that the latter half of 1903 and practically all of 1904 was an ideal period in which to invest money in high class bonds and stocks. We had gone through, prior to 1903, a period of several years of rapid business expansion and all business and financial statistics at the end of 1902 indicated that the business cycle was rapidly tending toward its logical phase of reaction and consequent liquidation. Money rates began to fall rapidly after having been very high, and through the latter half of 1903 and most of 1904 a country-wide condition of business dullness prevailed. Money was a drug on the market in Wall Street, the Stock Exchange was very inactive, prices of securities were low and yields on typical bonds and dividend-paying stocks were high.

In the spring and early summer of 1904 the average conservative investor feared to buy securities because of the pessimistic atmosphere and the apparently poor prospects of most business organ-

izations. But as a matter of fact this was the ideal time to make investments in proved securities. The men who were courageous and farseeing enough to buy sound bonds and good investment stocks throughout 1904, all invested wisely, as subsequent events proved. For the security markets began to revive in the last half of 1904, the trend was upward from that time on, and the rise in prices continued almost uninterruptedly until the opening of 1907.

A large number of investors were buyers of bonds and stocks during the last few months of 1906. On the surface many things looked attractive and the investment atmosphere was optimistic enough, but a study of the fundamental facts regarding the business and financial situation in the latter half of 1906 proved very clearly that the cycle had reached the unhealthy boom period and that there was great danger ahead.

Consequently, the last half of 1906 was a time during which no wise investor should have purchased anything. Rather, he should have liquidated his holdings of all securities except perhaps those of the very highest grade. Of course, most investors did not do this. They either added to their holdings or kept what they had on the theory that good times were going to continue forever.

It is such a simple matter to ascertain the fundamental condition and trend of the business cycle in normal times that it has always been a matter of

amazement to me that so few investors have shown any amount of intelligence in determining when to buy or when to sell investment securities.

The foregoing is a simple illustration and, of course, does not emphasize the cross currents and qualifying factors which often modify a given situation. But regardless of all of the many modifying factors, the fundamental condition of business and finance which existed in 1904 and which had completely reversed itself by the last half of 1906, overshadowed every other problem that the investor had.

In later chapters I shall show how investors can always successfully take advantage of investment cycles.

Chapter XIII

INVESTING FOR PROFIT

THE notion is widely held that any one who adopts the policy of investing primarily for profit rather than exclusively for income return is necessarily undergoing great risks, and that he is always taking great speculative chances which would be avoided if he confined himself solely to a policy of investing for pure income return.

It is undoubtedly true that the great majority of people who attempt to invest primarily for profit do run speculative risks. But a sound investment policy in this direction does not necessarily involve great risk. It all depends on whether the investor acts with genuine intelligence and knowledge.

In view of what has been said in foregoing chapters, it will be realized that no one can be at all certain of success in investing for profit unless he bases his plans very directly on a sound and continuous study of fundamental trends in the general business and investment cycle. The successful investor for profit is primarily what is known as the "long pull" investor. He is the man who buys securities with the confident expectation that an

upward trend in prices over a fairly long period will reward him with substantial profits. He must have reasons for the faith that is in him. If he is merely a man who buys securities with his eyes shut or as a result of rumor or tips, he is certainly nothing but a speculator. Some speculators have, through sheer luck or accident, reaped great profits at times, but 99 per cent. have failed in the long run.

Investing primarily for profit involves an intelligent understanding of the effect of general conditions and of special factors on different types of investments. It involves enough expertness and knowledge to enable a man, at particular periods, successfully to switch his holdings from one type of issue to another type or to several other types. There are no arbitrary rules for doing this at any stated times and, therefore, it involves the exercise of intelligent judgment all along the line.

To indicate clearly what investing for profit means, how it is done and what the results have sometimes been, I am going to submit the experience of one of my clients who during a period of approximately twenty years accumulated a large fortune by this method and without really taking any great speculative risks.

This man, who was a person of maturity and judgment, in 1904 invested about $50,000 in dividend-paying railroad stocks of high grade. These stocks were Great Northern preferred which he

bought at about 180, Delaware & Hudson which he bought at about 165, Delaware, Lackawanna & Western which he bought at about 260, Union Pacific which he bought at about 100, and Chicago & Northwestern which he bought at about 175. He purchased these stocks after a careful study of business and financial conditions and an intensive study of the railroads themselves. His inevitable conclusion was that they were all selling far below justifiable values and that as we were on the threshold of a business revival, they would certainly sell much higher within a year or so.

By the Fall of 1906 Great Northern had risen to 348, Delaware & Hudson to 234, Delaware, Lackawanna & Western to 560, Union Pacific to 195, and Chicago & Northwestern to over 240.

A renewed study of the financial and business situation at that time convinced this man that we were at the culmination of a boom and that 1907 would witness a severe financial collapse. He therefore immediately sold his holdings, approximately doubling his capital. During the ensuing year he reinvested his entire capital in high grade short term notes or loaned it on good security. At the end of 1907, with about $100,000 capital, he again invested in high grade dividend-paying stocks and in sound bonds. This time he diversified his capital into certain industrial securities such as General Electric and American Car & Foundry, as well as in

railroad stocks and bonds. His primary reason for this action was the clear demonstration by all the available facts that the country was again on a sound financial foundation and that there would therefore be a rebound and revival during 1908 and 1909.

This man held these new securities until the latter part of 1909. He sold out again before the opening of 1910 and had again doubled his capital.

From 1910 on for several years the business and financial trends in this country were decidedly mixed and it was extremely difficult to accomplish much by following the method which had proved so successful before. Consequently, this man, for several years, confined his investments primarily to bond issues of substantial quality and high grade dividend-paying stocks. As he used exceptional intelligence, however, he was able, at the end of three years, to show a further profit on his principal of 20 per cent., in addition to having had it invested at an average return of 6 per cent. during all that time.

With the opening of 1914 this wise investor, who was an intelligent student of general conditions, concluded that there was danger ahead in both this country and Europe. The breaking out of the Mexican revolution, the political changes which had taken place, the continued unsettlement of the Balkan Wars in Central Europe and the dubious out-

look in Western Europe, were all taken into consideration. Consequently, when he noted, in the spring of 1914, that enormous amounts of American and British securities held by Germans were being sold in London, Paris, and New York, he decided that it was time for him to cash in. He sold everything that he had except certain extremely high grade bonds. His investment capital was kept liquid and loaned temporarily on good security.

When the World War opened in August, 1914, this man did not become panic stricken. He studied the situation in all its aspects. He realized on careful reflection that if the war continued for any great length of time it would bring about a great business boom in this country and that credit conditions in the United States would not be upset, as the balance of trade with Europe would turn sharply in favor of this country and gold in enormous sums would be sent here from abroad. These were fundamental facts which quite positively pointed to a great rise in the security markets at no distant date.

Consequently, in December, 1914, and January, 1915, this man invested his entire capital in stocks like Bethlehem Steel, United States Steel, General Electric, American Car & Foundry, the Standard Oil issues, motor stocks, leather stocks and other manufacturing company stocks. He knew full well that the abnormal war situation would create a vast

demand for every type of commodity which Europe would need.

Of course, in making this move he got the benefits of the inflation and speculation which followed, and a large percentage of his ensuing profits were due to this speculative condition. But the point to be emphasized is that he bought these securities for sound basic reasons and on a level of prices which was decidedly not a speculative level.

Everybody knows what happened in the security markets in 1915 and 1916. Vast fortunes were made by speculators and others, but on the other hand, vast fortunes were lost. This particular man, who was acting on sound premises, made a vast sum but did not lose it. He did not lose it because along in 1916 he realized that the United States was slowly being drawn into the war, and that the reasons for the speculative war boom in American securities, on which he had based his judgment, would soon be eliminated. Consequently he sold practically everything once more.

The United States went into the war in the spring of 1917. This event was marked by a sharp recession in the prices of practically all types of investment securities, including bonds of every class, railroad stocks of every kind, and practically all industrial securities except those specialties which were being very directly benefited by the increased demands for war munitions and war supplies. The following

year and a half was a time of unsettlement in this country and uncertainty in the security markets. This man consequently followed his traditional policy of caution and conservatism and the bulk of his capital was kept liquid in loans, although he placed a large percentage of it in Liberty Bonds.

The early fall of 1918 foreshadowed the end of the war and it was a simple matter to foresee that there would be a return of confidence and a rebound in security prices. After the war ended most people thought they foresaw a period of business depression immediately ahead because of the fact that war contracts everywhere would be cancelled and the demand for war munitions would immediately cease. But such people overlooked the psychological side of the situation. They did not realize that the culmination of the World War would invite a period of wild speculation and inflation which would not be long in making itself felt.

Consequently, the investor we have in mind confidently bought various types of good securities in the fall of 1918. He did not buy anything in the railroad field except certain high grade bonds, but he purchased industrial and miscellaneous stocks such as General Electric, American Car & Foundry, F. W. Woolworth, etc. These he held right through until the end of 1919. He then once more sold out practically everything he had for he was student enough to foresee the coming collapse of the infla-

tion bubble and knew that the time was not far distant when most securities would once more be selling far below their intrinsic values.

What happened to this man after 1919? He had by that time accumulated nearly $2,000,000. He did not at once reinvest these funds permanently; he waited until 1921 when he put three-quarters of his fortune into high grade bonds of various types, and the balance into dividend-paying stocks, among which were F. W. Woolworth, American Bank Note Company common, American Can Company preferred, United States Steel, New York Central, Illinois Central, and Atlantic Coast Line.

My latest information is that this investor had retained practically all of these securities, at least up to the fall of 1924. His total capital up to that time had been augmented to considerably over $2,000,000 and was showing him an average yield of more than 6 per cent. on the money.

This case is a very exceptional one. But the points to be emphasized in it are these: The man achieved this result over the twenty-year period without ever having bought securities on narrow margins or going deeply into debt to pay for them. He did not always reinvest his full income, as he was all the time living on a part of this income. He made it a rule never to buy or sell a security on the strength of rumors, guesses, tips, or so-called inside information.

Of course, he made a few mistakes of selection and here and there had to charge off moderate losses. But as a whole he displayed remarkable wisdom and judgment.

Naturally only the exceptional investor could expect to have such success as this. It is a matter of temperament as well as knowledge, and the average person always finds it extremely difficult to act consistently on common sense principles and not allow judgment to be warped or destroyed.

Investing for profit, as illustrated by the experience of this man, is sound and safe, but only so when full knowledge of all the factors, general or specific, are available, and when sound judgment can be employed in connection with these factors. The average person can never hope for perfection and can only approximate correctness.

Consequently, it would be a rash and dangerous thing for the average investor to attempt to invest exclusively for profit.

The proper program for investors to follow is first to consider the security of their principal and invariably confine their selections to securities which stand on a sound investment plane, regardless of changing business conditions. Such securities are found in every group, whether railroads, public utilities, industrials, governments, or miscellaneous enterprises. They are the securities which in every instance are entitled to strong investment ratings.

These are the only issues worthy of consideration for any one who wishes to invest and not speculate.

Contrary to the assumption of many people, there are better opportunities, and more certain ones, for investing for profit in the higher grade groups than in lower grade groups. The moment a person begins to seek issues on the speculative plane, he is abandoning investment principles and taking the type of chances which never can be justified by common sense or experience.

There are those who hold to the view that the safest form of investment is that which never gives thought to changing trends and does not take into consideration the possibilities of prices rising or falling over extended periods. But it can easily be shown that this theory, while it has some truth, has not all the truth. Thousands of investors have not only lost opportunities to invest their money permanently at a liberal average return, but have also frequently lost large amounts of their principal by giving no attention to changing conditions or trends of a fundamental nature. As an illustration, I will mention the case of a man who some years ago submitted to me a list of very high grade bonds which he had inherited and which had apparently been purchased twenty years or more before. The cost of these securities had approximated $100,000. The yield at this cost had been about 4 per cent., but all of the bonds had been purchased at very high

premiums and most of them were 5 or 6 per cent. issues. The *par value* of these securities was about $75,000, and the total annual interest amounted to about $4,000. The holder of these bonds had paid no attention, during his life, to changing interest rates throughout the country or to the changing purchasing power of the dollar. He had spent all of his interest each year and had died assuming that he was leaving $100,000 worth of securities to his heir.

As a matter of fact, you will see that this man was leaving not $100,000 but about $75,000. While he had originally invested $100,000, he had actually been spending a part of his principal every year and did not know it. For at the time the list was submitted to me most of these bonds were approaching maturity and the market prices had declined and wiped out practically all the former premiums on the bonds. Consequently, during twenty years an investment fund of the very highest grade type resulted in a loss of 25 per cent. of the principal.

Had this investor given any serious attention to the trend of interest rates, to the changing purchasing power of the dollar, and to the factor of maturity of these bonds, he would certainly have made changes in his investments from time to time. He would have followed at least a partial policy of investing for profit and would have switched his capital into types of securities which would hold

their values as the years went by. Moreover, he would have recognized that as the cost of living rose his income was actually getting smaller, and it therefore would be absolutely necessary for him to increase the nominal amount of his annual income if he wished to keep his money safely and soundly invested. For an income of $4,000 per year in 1910 was, ten years or so later, really equivalent to only about $2,000, so far as purchasing power was concerned. And the only successful investors during that period were the people who were able, without taking chances and without endangering their principal, to increase their nominal income as the general cost of living rose.

Chapter XIV

INVESTING FOR "SAFETY PLUS"

THE effect on security values of recurring cycles of prosperity and depression indicates how complicated and difficult a problem it is for the average investor to assure himself of safety. Even though he may consistently follow a policy of putting all of his capital into the highest grade *Aaa* bonds, he is not then assured of keeping his capital permanently intact. He can, of course, be practically certain of a definite specified income by concentrating on the various highest grade issues, but the value of his principal being subject to the fluctuating changes in interest rates and the purchasing power of the dollar, he is not even then fully protected.

One must adopt a policy of what is called "constructive investing" if he is to get the best results and most completely protect himself in the matter of both principal and income.

Constructive investing is investing for safety plus profit. It has nothing whatever to do with speculation and avoids the purchase of low grade and unseasoned bonds or stocks quite as much as it for-

bids the dangerous method of attempting to guide one's operations by forecasts of short moves in the stock market.

Constructive investing, in a word, consists of buying and holding only securities of sound investment character, making changes in one's list in accordance with developments affecting the security of one's holdings and in accordance with changing conditions in the investment markets. Such a program does not require day-to-day attention to bond and stock quotations. It is a plan which can be followed by investors who keep themselves fully informed on the condition of the concerns in which they have invested and on the broad movements of business and commerce in general, and who act with intelligence in the light of such developments — and then sit tight.

There are several outstanding and essential factors to recognize in applying the principles of constructive investment. Briefly, they may be classified as follows:

1. Safety and security. The first act of the investor should be to examine carefully all of the facts in relation to a specific security. If, for example, he proposes to buy an *Aaa* bond like Oregon-Washington Railroad & Navigation Company First 4s, he will first study the financial statements of that company. He will ascertain the location of the property, its earnings over a series of years, the

characteristics of the territory covered, the types of business done, the tonnage exhibits, the freight and passenger rate situation and so forth. He will then examine the terms of the mortgage itself or a digest of this mortgage and ascertain just how the bond is secured and what relation the earning power has to the interest requirements. He will then determine, by an examination of the balance sheet, the general position of this issue and see whether the physical value of the property is sufficient to protect a mortgage of this particular type.

Having examined these figures, he may feel that they do not appear to justify so high a rating for the bond. But he will discover that this particular bond is guaranteed principal and interest by endorsement by the Union Pacific Railroad Company, and that this guarantee is an important element in the security of the issue. This will lead him to an examination of the Union Pacific Railroad, its earning power, resources, credit and so forth, and indicate the value of the Oregon property to the main system. The Union Pacific exhibits will undoubtedly convince him of the high quality of the bond as an investment.

2. But if he purchases the bond as a result of this examination and ignores all other factors, he may be making a mistake. This particular bond was issued in 1914 and sold as high as 92 in that year. But by 1918 it had dropped to about 65 and in 1920

was as low as 62. In fact, at no time in the last ten years has the bond sold as high as 92 and even as late as the summer of 1925, it was quoted around 84. Consequently, the investor who bought these bonds on the strength of their security only has not had any chance for ten years to get his money back by selling the bonds. No one, therefore, would say that this bond was an ideal investment in 1914 even though it was so highly secured. Therefore, the investor, after he has studied a particular issue and found it good, should next turn to the prevailing interest rate situation and the general trend of financial or business conditions. A careful study of the investment cycle would prove to him that while this bond was a poor purchase in 1914, it began to be a very attractive thing to buy in 1918 and has been relatively attractive ever since. In 1920 it sold as low as 62, in 1921 as low as 67½ and in 1923 as low as 75½. In recent years the bond has been slowly creeping back toward its original value.

3. A study of the interest rate and investment cycle, it will be seen, will indicate when this particular bond was a profitable thing to buy. But it is also necessary to know whether, having bought the bond around the low level in an investment cycle, it should later be sold or held indefinitely. It might turn out that in another five years the price would be back to the low figures of 1920, and therefore the constructive investor must be just as able to deter-

mine when he is to dispose of his holding as when it is wise to buy it. This involves an examination first of the date of maturity. If this date is only a few years away, such a bond would naturally hold its value and slowly approach to par. But the bond under discusion does not mature until 1961 and there may be several major investment cycles during the interval. Consequently, it is an important question as to how long he should hold the bond. To determine the answer to this question one must study long range fundamental trends. He must, for example, try to ascertain whether at the present time we are in a period in which world interest rates, cost of living and commodity prices in general are tending downward or upward. If downward over the next thirty or forty years, then his policy would be more strongly to hold this bond through fluctuating changes. If upward, his policy should be to take advantage of one of the three- or five-year upward swings in the investment cycle to switch into something else.

The above policies apply to practically all classes of the highest grade *Aaa* bonds, and if an investor's holdings were limited and confined to one or a few issues of this type, he would not need to give much study to anything else, except to bear always in mind that the world is moving on and that customs change and a type of business which is now normal might become obsolete a generation hence.

But constructive investing in its broadest sense means a great deal more than merely confining one's funds to bonds of this type. It may be sound investing to do this, but not always very profitable investing.

The really constructive investor who has substantial capital available should subdivide his funds into various classes of securities. Broadly speaking, this division might in these days be made in approximately the following proportions:

Twenty-five per cent. in railroad securities, 25 per cent. in public utility securities, 20 per cent. in American industrial securities, 20 per cent. in foreign securities, 10 per cent. in American Government and Municipal securities.

The question as to a percentage of division between bonds and stocks of corporations cannot be so arbitrarily stated. This is a fluctuating problem, for there are occasions when one might wisely have most of his railroad investments represented by stocks and there are other occasions when he ought to confine his selections mainly to bonds. But in all instances, if he is an investor and not a speculator, everything he selects should be on a genuine investment plane and carry a good investment rating. Bonds which carry Moody's *Aaa, Aa, A* or *Baa* ratings are almost exclusively the types of issues to which the investor should confine his purchases. In the case of stocks, generally no issues rated

below *Baa* should be considered. In these fields the investor has unnumbered opportunities for intelligent selection.

But the fact cannot be too strongly emphasized that constructive or sound investing implies not merely the adoption of a wise policy in selection and diversification, but it further involves the complicated problem of keeping one's capital continuously invested wisely. This cannot be done unless the investor is prepared, year in and year out, to watch his investments or have them properly supervised. What he should have done in 1920 may have no relation whatever to what he should have done in 1925. In the year 1920 the level of prices of railroad investments was abnormally low and one could almost shut one's eyes and buy railroad bonds and sound railroad stocks with safety. In fact, during that year, not only railroads but public utilities, a large percentage of good industrials, and many government bonds were on the bargain counter. Even Liberty Bonds in 1920 and 1921 sold at heavy discounts. On the other hand, European government bonds were by no means the bargains that they became a year or two later.

Consequently, the investor who was starting his work in 1920 or 1921 would have courageously bought railroad bonds and stocks and public utilities of high grade, and with a selection of industrials, but would not have bought many foreign issues. He

would have bought long term bonds and retained the bulk of them until the latter part of 1925 when he would perhaps have begun to exchange some of them for shorter term bonds or certain other securities. He would have held his industrial stocks, for the most part, until some time early in 1923 and then sold them, putting his funds temporarily into short term obligations. But by the end of 1923 or during the first months of 1924, he would have given attention to foreign government bonds and would have employed his liquid capital in their purchase. But during this entire period of five years he would have made but few changes in his holdings of public utility bonds or stocks and few changes in his railroad holdings. He would perhaps have realized on high grade bonds like Liberty loans some time in 1924 or 1925.

Let us submit another illustration of a constructive method for investment which confines the policy entirely to the field of the highest grade bonds. As already pointed out, bonds of the class which carry an *Aaa* rating, respond more directly in their price movements to slow changes in the world's interest rate than to anything else. They do not necessarily keep exact pace with changes in the interest trend but over reasonably long periods of time they reflect this trend pretty accurately.

Let us therefore take the case of a high grade investor, such as an insurance company or other

institution which, because of legal limitations or very conservative policy, invests its funds only in certain specified types of seasoned high grade bonds. If such a concern twenty or twenty-five years ago were investing its money in a really constructive way, special attention would have been given to the question of maturity. In those days very long term bonds were popular. They were popular mainly because of the mistaken theory that the world's interest rate would persistently tend downward for many decades into the future. This, however, proved to be a mistake, and instead of interest rates tending downward, they were even at that time beginning the long upward trend which did not culminate until after the years of the war. This tendency could have been demonstrated even in those times and thoughtful students of underlying conditions foresaw this more or less clearly.

The constructive investor in those days should not have bought long term, high grade bonds unless he was buying them for temporary purposes only. His every effort should have been in the direction of seeking out short term obligations maturing within ten years at the latest. An examination of bond price trends during the subsequent period of fifteen to twenty years will show that the man who in those days gave primary attention to short term selections, was the really constructive investor. During all that period he was continu-

ously in a position where he could avoid the dangers of long drawn out and permanent depreciation in his invested capital. Periodically his securities would mature and could be easily changed into other short term obligations running a few years more. Where his selections were made at the proper time and wisely, he was frequently able to get the benefit of moderate profits which would offset any minor losses which might have occurred.

Such a man, however, would not necessarily continue to be a short term investor for the rest of his life. As a matter of fact, when the period of 1920 or 1921 had arrived, he would have changed his policy and instead of seeking short term obligations, would look for long term issues of equal quality.

Thus this man, by the opening of 1925, would have been able to look back over a period of a quarter of a century and witness an investment policy which had been absolutely sound. At no long periods would he ever have been confronted with serious losses in his principal and he would finally have put his funds into a position where they would be getting the benefit, protection and advantages of the fundamental change in the trend of world interest rates which set in a few years after the close of the war.

Still another illustration. Let us consider the type of investor who does not limit his selections to the highest grade bonds but is also willing to

consider more medium grade issues and stock issues when they meet the proper investment tests. Such a man would, in times of inflation and general speculation, switch his capital almost entirely into high grade, short term issues or else keep it in some other liquid form. He would, however, courageously buy, in a period of panic or depression, stock issues of the type which, on investigation, would prove to be intrinsically worth more than their market price and would therefore assuredly respond to the ultimate return of industrial or business prosperity. This man would never buy stocks, even of the highest grade type, in periods of boom. But in times of depression he would not bother with bonds except of the grades which respond, as stocks do, to business conditions.

These are simply broad principles that I am mentioning. What must be emphasized is the fact that in order to follow such constructive plans definitely, every investor must either become a thorough and qualified student of all the influences and factors, fundamental or specific, or else he must be in a position to employ others to do this for him. The average investor cannot, unaided, manage his investment funds constructively any more than the average individual can settle legal problems without expert guidance or than the average person can always successfully doctor himself when sick without professional aid.

Chapter XV

INSTITUTIONAL INVESTING

THE term "institutional investing" is a very broad one and refers to the investment policies of all types of institutions, whether those which are engaged in seeking profit, such as banks and trust companies, or those which are not generally operated for profit, such as insurance companies, savings banks, and educational, charitable or other institutions of any kind. In the United States institutional investing has become a very important function, especially since the days of the very rapid expansion in the size and number of banking and other financial institutions, of insurance and guarantee companies of various classes, and finally, of the enormous increase in the number of educational and charitable institutions of many kinds.

With the rapid increase in American wealth and the growth of the multi-millionaire classes, the endowment funds of charitable and educational institutions have become very far-reaching factors in the investment field. In these days it is undoubtedly true that a large percentage of high grade securities are held by institutions which have had the benefit

of heavy endowments. Within the past decade hundreds of millions of dollars have been endowed to institutions in the United States, and the great bulk of these endowments has taken the form of permanent investment funds. Consequently the institutional investing field has grown more and more important as time has gone on, and promises to become still more important in the years to come.

It goes without saying that the investments of any substantial type of institution should be high grade ones. No institution of any character should speculate with its funds or take chances of any kind which would make serious losses possible. In the case of banking institutions and, for the most part, in that of insurance companies, the laws of the nation and of the various states do much to regulate and restrict the choice of investments. But unfortunately these laws in many cases are inadequate or partially unsound and consequently the field is sometimes pretty wide open for such investors to make many mistakes.

The danger of mistakes of judgment and bad investment selections are still greater in the case of such institutions as are not rigidly regulated by law. Many charitable and educational institutions are not protected in their investment limitations by sufficient legal restrictions, and the selection of their investments often resolves itself wholly into a question of judgment by the management itself. Fur-

ther than this, practically all endowed institutions of any size are constantly inheriting legacies in the form of all sorts of securities, some good and some very bad. Therefore, more than in almost any other field, the questions of investment policy, judgment, and selection are constantly up for decision.

In the banking field, investment in bonds has become an outstanding function within the past ten years. Prior to 1914, before the Federal Reserve Law took effect, the national banks of the United States were not outstanding bond investors. The old law restricted the investment of their funds in a more arbitrary way, and while certain types of bond obligations could be held by national banks, the bulk of them could not. The same thing was true of state banks in many states in the union.

But nowadays national and state banks and trust companies represent an important percentage of the total American investment market. During the war years the financing of Liberty loans and other war obligations brought the banks of the country into the investment field in a very large way and from that time on the investment of banking funds in bond obligations has steadily grown until it has reached the vast proportions which prevail to-day. Under present laws national banks are necessarily large investors and many of them have found it profitable, in these days of general corporate activities, to organize great investment departments and

carry a far larger percentage of their deposits and reserves in bond and note issues than was dreamed of a decade ago.

The problem of bank investments is necessarily complicated by the characteristics, type of business, and location of each individual bank. In some sections of the country bank resources fluctuate far more widely than in others. Bank reserves rise and fall, loans expand and contract, with more uniformity in sections of the country where business turnover occurs or crops are moved at certain definite seasons of the year than in other places, like large cities, where diversified trade conditions almost dominate the situation. Naturally, therefore, the bank which is located in territory where there are permanent and stable business activities, need not necessarily keep its investment funds so liquid as need the banks in some other sections of the country.

A banking institution should, of course, give more attention to the question of liquidity in its investments than almost any other class. Consequently, one of the outstanding considerations in a bank investment should be the market for the particular issue. Whereas some other type of institution or some permanent individual investor can often afford to place his money in high-grade issues with a limited or uncertain market, the banking institution can seldom afford to do this. Bank deposits and bank resources are liquid capital and therefore they should naturally be kept in liquid form.

The same fact applies more or less to the funds of institutions such as insurance companies. Insurance companies build up reserves which in the aggregate, if the company is successful, are permanent reserves. They are permanent enough to justify the company in investing a substantial proportion of such reserves in permanent forms, but nevertheless a good percentage of such reserves should always be kept in liquid form.

It will be seen from the foregoing comments that the problem of maturity in bank and insurance company investments is an important one. Short term obligations, other things being equal, are always better for a bank and often better for an insurance company, than are the longer term issues. A short term bond will almost inevitably have the benefit of a good market and, of course, generally maintains its value in a more stable way than does the long term obligation. The long term obligation, as has frequently been pointed out in this book, regardless of its security, is subject to money market conditions, the trend of interest rates, and often declines and stays at low prices for a long series of years. On the other hand, the obligation due shortly will hold its approximate market value right in the face of unsettlement and tight money.

While it is not necessary nor even desirable for banks and insurance companies to confine all of their investments to the very highest grade issues,

such as United States Government obligations or high grade municipal bonds, yet it is important that a sharp line should be drawn between issues of distinct investment merit and those carrying a speculative tinge. As a general rule, good banking practice in this country has adopted the plan of restricting bond investments to the types of issues which are rated *A* or higher by Moody's. It is, of course, well to have a large proportion of *Aaa* bonds in the vaults of a bank but, generally speaking, bonds which are slightly less seasoned or somewhat lower grade, but which carry ratings of *Aa* or *A*, can well be mixed with the more seasoned issues. But it is seldom that a bond carrying a lower rating than those mentioned is entirely desirable for institutions of this type.

It has become more and more the custom, within the past half-dozen years, for banking institutions to shift their investment funds from time to time in response to money market and business conditions and in accordance with the general movement of the business cycle. This policy involves expertness and study and naturally carries its dangers unless care is taken and sound judgment used. But there is no reason why a banking institution cannot afford to take advantage of changes in conditions within a carefully restricted field. The bank managements that were wise and farseeing enough to buy seasoned, high grade corporation bonds in 1921, at the

low prices which then prevailed, have no reason to regret their action, and the bank managements who have at the proper time shifted their very short term investments into moderately long term issues, when conditions warranted it, have usually shown great wisdom.

The only danger of importance in following this policy is that there is always a strong temptation to overstep conservative lines and take undue chances. Whenever there is any doubt as to the policy in this respect, the bank management should give itself the benefit of the doubt. If the prevailing average yield in a given period on high grade, sound securities is around 5 per cent., it is only a foolish banker who will reach out to try to get 6 per cent. The difference between 5 and 6 per cent. is only 1 per cent. and it is not worth enough to justify any one's taking any chance whatever with the integrity of his principal. The banker, more than almost any other man, should be constantly impressed with the truth that, in investing money, security of principal is far more important than increase in income yield, and always will be. This truth should always be the cornerstone policy of any one who is investing other people's money.

In the general field of charitable and educational institutions, investment policy need not necessarily be restricted in the same way that bank investment should be. An educational institution, such as a

college, receives endowments in various ways which it is usually necessary to invest permanently. These endowments do not often take the form of liquid reserves and are looked upon mainly as permanent reserves. Unless the endowment is something which is shortly to be used for improvements or buildings, it is invested for the purpose of permanently securing income for use in some way in the institution. Funds of this kind will presumably remain intact for indefinite periods and therefore can well be invested in long term obligations. It is usually better for the management of such an institution to place the funds in long term bonds, rather than to attempt to take advantage of fluctuating prices or yields and keep the funds liquid. This general principle applies to hospitals, endowed churches and other religious organizations, as well as permanent charitable institutions. The ideal situation for any institution of this nature is to accumulate and permanently protect a large reserve which will absolutely insure a definite amount of revenue from year to year.

The most successful managements of institutions in the United States have long followed this general plan and if one could examine the strong boxes of the greatest American universities, endowed schools, hospitals, and religious institutions, one would probably find that the bulk of their funds was well invested in highly protected obligations for all

time. This policy is one which should never be abandoned.

But the problem of the endowed institutions is not limited to that of investing cash funds or accumulating reserves. As already pointed out, endowments come into institutions in every possible form and often the institution finds itself presented with types of speculative issues with which it knows not what to do. Too often, through bad advice or doubt, such bequests have been kept in the form in which they have been received, and in a little while the institution has found itself an unwilling speculator in doubtful securities. As a general principle, therefore, it is sound policy for any institution to cash in its bequests as rapidly as possible where they are of a doubtful nature. It may often prove that they have been sold too cheaply, but on the other hand, it often occurs that by holding them they become entirely worthless.

It will thus be seen that, after all, institutional investing involves a pretty thorough knowledge of all of the fundamental factors which affect investment values in general. Whereas the bank or other type of institution, whether operated for money making or not, must necessarily confine its investment selections to high grade issues, the best judgment cannot be exercised without having full knowledge of general business and financial trends. Investors in Liberty Bonds know well that during the past five

years there have been times when the purchase of these bonds was wise and also times when it was much better to keep their capital liquid or defer purchases. Even the very high grade obligations of short term variety fluctuate to a considerable extent during certain periods, and it is for the institution to use intelligence in connection with cycle movements of this kind.

Furthermore, an important consideration for the institutional investor is to take full recognition of investment yields. Too often do investors forget that as bonds approach maturity their yield is directly affected, and that, by a wise and careful study of conditions, they can often realize on an investment on a better basis than had been originally planned. As an instance, take the case of a high grade railroad bond like Michigan Central 4s, due 1929. Six years ago these bonds, while undeniably high grade, were selling below 80. They had ten years to run, and therefore the purchaser at that time had a splendid ten-year investment insuring him a large income to maturity, as the principal would be payable at par in 1929. But in 1925, or four years prior to maturity, these bonds had risen to only two points below their par value. Consequently, the investor who purchased the bond at 80 in 1919 would find it far more profitable to cash in at 98 in 1925. rather than hold the bond for par in 1929. By 1925 the bond had risen eighteen points from the cost

figure, and during the period from 1925 to 1929 it cannot possibly rise over two points more.

Problems of this type constantly come up with the investor in high grade securities, and efficient investment methods require that they be given careful and expert attention.

Chapter XVI

INVESTMENTS FOR BUSINESS MEN

THE typical successful business man who earns each year a substantial surplus above his expenses and current needs in his business, more often than not becomes an investor in bonds and stocks. Probably a very high percentage of the bond and stock purchases of investors in this country are those of business men, so-called.

The term " business man " as here used, refers not only to the individual or individuals who are heads of their own firms or partnerships, but includes all types of men who are in business life in all sorts of capacities, even though a very high percentage of them are simply corporation officials or high class clerks. They are men who not only live on profits derived from business activities, but also those who live on substantial salaries, commissions or revenues of similar type. In other words, the business men class is that class which is not living merely on investment income but is doing something continuously toward the general production of wealth.

It has become the fashion in recent years to designate as business men's investments a large class of

securities which are neither very high grade nor very low grade. It is contended that the business man, as such, does not need to put his surplus funds into the highest grade seasoned investments, as he is more in a position to watch his investments than the average investor and can therefore afford to take greater risks. It has always seemed to me that there is something unsound in this argument. While it may apply in many cases, it is certainly not sound as a general proposition.

The business man is supposed to be a person whose familiarity with business and financial conditions generally is such that he can pick and choose an investment more intelligently than can a widow or an orphan or a person who is not in direct contact with business life. Being familiar with quotations, markets and so forth, it is assumed that he can give more time and more intelligent attention to conditions surrounding speculative securities than can the person who is in some other walk of life.

But is this true? An active business man, whether the head of a business, a partner, an official or a clerk, must necessarily give the best of his intelligence and time to the thing which he is actively engaged in. He has not the leisure to study investment values and usually he cannot afford to divert himself from his main occupation, which is his business, to that of watching and analyzing the financial markets. It has long seemed to me that more, al-

most, than any other class, the typical business man is one who needs high grade investments rather than speculative ones.

With the great majority of men in business, their speculation in life is their business. Every business is a speculation more or less, and many men are successful in their occupation simply because they become expert in the thing which they are daily doing and understand its risks and its opportunities far more than does the outside public. Consequently, the typical business man should, if he is successful enough to accumulate surplus capital which he does not need in his business, put such surplus capital into sound securities which do not require careful and daily watching.

It would seem absurd to a practical business man whose occupation was that of the sale of clothing, to invest his surplus capital in a minor way in some restaurant or shoe store one thousand miles away from his own location. If a resident of New York City is asked to invest $5,000 in a restaurant in San Francisco, about which he knows nothing except the fact that it is a success and is being run on legitimate lines, he would almost certainly say that he knew nothing about the restaurant business and that unless he controlled it and could have a voice in its management, he would be a fool to put money into it. And yet, the same man is told that he should put his $5,000 into some bond or stock

which is called a "business man's investment" and which represents a small interest in some enterprise or undertaking far away from home. Of course, the only compensating factor in this operation to him would be that perhaps there is an excellent market for this stock or bond, and he thus may have the possible chance of sooner or later selling out at a profit.

But this is speculating and not investing, and business men who follow this general policy really have two speculations, one their own business and the other their so-called investments.

Many years ago a business man who was at the head of a substantial commercial enterprise in New York City, said to me that he had been taking out about $10,000 a year from his profits for ten years or more and investing these sums in securities as a reserve for his old age. He was evidently making from $30,000 to $50,000 a year in his own business. But instead of putting this $10,000 a year into high grade, well secured bonds, he was spreading it out over a large list of medium or low grade securities and was carrying a large line of more or less speculative stocks on margin. I remarked at the time that I did not believe it would pay him in the long run to follow this policy and that in ten years' time he would be much better off if he stuck to some plan of investing his money permanently on a 5 per cent. or 6 per cent. basis. He laughed at this, remarking

that he had never lost anything worth while yet and that sooner or later he would make a big stake in the market.

Fifteen years rolled by and one day this man came into my office. He looked thirty years older, broken down physically and was by no means the upstanding type of man of the old days. He told me his story and prefaced it by remarking that " the advice you gave me fifteen years ago was right but I have only recently realized it."

He said that during the entire period of fifteen years he had been investing his money in speculative securities, in stock market trades and in looking for his great opportunity to make a clean-up.

" The result has been," he said, " that my business has dried up simply because I could not give exclusive attention to it. All these years I have had to watch quotations and the stock ticker and keep track of my securities. This situation ultimately affected my health and I have just come out of a sanitarium after a three years' stay. I still have the bulk of my capital, but although fifteen years have gone by, I find that my average return in interest or dividends, after deducting losses and expenses, has been less than 2 per cent. per annum. On the other hand, I find that in fifteen years' time I have paid out to stock and bond brokers no less than $140,000 in commissions and interest.

" Now," said he, " I have finally come to my

senses and am investing the moderate sum I have in high class bonds which are entitled to sound investment ratings."

Probably this story could be repeated thousands of times among American business men. Perhaps every one with anything like a wide business acquaintance knows of cases which duplicate this one. An enormous number of American business men are constantly making substantial money in their own lines of business which they know all about and are regularly and religiously dropping this same money in Wall Street year after year. Most of them never seem to learn very much by experience.

There are, however, true business men's investments. They are always high class investments. They are always the types of stocks and bonds which are so secure and so stable that the tired business man, when he goes to bed at night, can sleep. The very moment a business man gets hold of an investment which keeps him awake nights, it is no longer an investment which a business man should have.

It seems unnecessary to emphasize the fact that the first consideration that should be given full weight by any business man in investing money is to confine his selections to securities which will not divert his attention from his business, which will not impair his health and which will not disturb his sleep. The true purpose of a business man's investment should be something which will enable

him to sleep better and not poorer. This implies that it should be something of exceptional security which does not fluctuate in a speculative market under all ordinary conditions, and which constantly gives him the feeling of having a secure reserve.

Of course, I do not wish to imply that business men should confine their investment selections exclusively to fixed income-bearing securities or to the types of bonds which are in the *Aaa* class. A business man can afford to buy many junior bonds of demonstrated security and also can afford to buy high grade stock issues. But no business man who is really active in business life and has capital at stake, can afford to trade aggressively in securities or buy and sell stocks or bonds for short turns and primarily for securing quick profits.

On the other hand, he often can afford to purchase securities for the so-called long pull. This involves careful selection and exhaustive research at all times. If he is as intelligent in his investment policy as he may be in his own business policy, he will select securities for long term holding only after he has developed sound reasons for doing so. In brief, he will follow the same mental process in purchasing a stock issue that he follows in purchasing the type of commodity in which he deals. If a man is in the leather business, he becomes perhaps an expert in the leather market and when he makes large purchases he has sound reasons for doing so.

His judgment may be wrong, but nevertheless he exercises his judgment and does not make his purchase on mere impulse or sentiment. And he should make his security purchases on the same plan.

I have in mind a wise business man who in following this policy for a series of years has been extremely successful. Ten years ago he made a careful study of the chain store business and then made an intensive study of the business and financial condition of the Woolworth Company. He gave the same kind of intelligent thought to this matter that he would have given had he planned to go into the chain store business himself. Finally, being satisfied that his judgment was sound, he purchased a substantial block of Woolworth Company common at $120 a share, paying cash for it, and putting the certificates in his safe deposit box. During the following years Woolworth stock fluctuated more or less widely, but the trend was always upward.

The average speculative investor or ordinary business man would no doubt have sold this stock after a twenty or thirty-point advance, as the dividends were not extraordinarily high for a stock of this price. But this man had studied the business, saw its possibilities and continued to hold the stock as an investment. When I last heard of him he still had this investment.

Some people would say that this man has reaped a great speculative profit. He has reaped a great

profit, but his motive was not speculation; his judgment was not based on a speculative proposition in the ordinary sense, and he has more than doubled his capital simply because he knew what he was buying and continued to have faith in it.

It will be seen, therefore, that successful investing for business men should involve the same conservative and logical policies of sound judgment and conservatism that are required for all genuine investing. The very moment one steps over the line and begins to take chances on the theory that he can watch his problem closely, he is no longer an investor but has become a speculator.

While the general statement is made that the American investment field is made up, to a large extent, among business men, yet as a matter of fact it is probably true that only a small proportion of these business men investors are genuine investors. Most of them are speculators whether they know it or not. They are constantly being appealed to by sellers of semi-speculative securities on the theory that speculative investments are safer in their hands than in the hands of the ordinary person. But as I have tried to demonstrate, this is not true.

The only type of business man who can afford to take speculative or semi-speculative chances in his security selections is the man whose own business is not a speculation to any extent, and who is so entrenched with his business income, whatever it

may be, that regardless of developments, it will surely go on. There are, of course, many such men in this country. There are businesses of large size so well founded and so strongly protected by exclusive rights, great prestige, large capital, or enormous good will, that even criminally poor management can scarcely injure them.

The story was once told to me of a certain large business in New York City which had been established fifty years or more ago but which had been grossly mismanaged and neglected for over twenty years. And yet, because of its character and secure position, it was still making just about as great a profit each year as ever. This business is still going on in the same way, and, so far as I can see, can run a century yet. Perhaps the people who own this business can afford to take speculative chances in their outside ventures if they care to. But such a business is decidedly the exception rather than the rule.

It all comes down to a question of security after all. The business man who buys either stocks or bonds because they are listed on some stock exchange and therefore have apparently a wide and active market, is not by any means giving all the thought to the matter that he should. In these days of the creation of new securities in enormous quantities, the great majority of which are not listed on exchanges, the question of active markets is a very

different one from that of thirty years ago. It is almost as easy for one to buy or sell an unlisted bond of genuine character as it is for him to buy or sell Liberty Bonds on the New York Stock Exchange.

The investment banking business has developed so enormously in recent years that nowadays one can, in any city or substantial town in the United States, buy desirable securities across the counter as he can buy a hat or a pair of shoes.

Knowledge of the facts is the thing that usually makes a man successful in business, and knowledge of all investment facts is the main thing that makes a business man a successful investor.

Chapter XVII

INVESTMENT POLICIES FOR WOMEN

THE great outstanding class of investors who require, more than any other class, careful guidance in the employment of their investment funds, are women and others who are more or less directly dependent upon their investment income for their living. Added to this might be classed the people, generally, who live on moderate salaries and attempt to do a little systematic saving from year to year.

At the outset it should be emphasized that none of these people should attempt to speculate in either stocks or bonds. The importance to them of absolute security of principal is very great and should not be overlooked for a moment. In the vast majority of cases the amount of their principal is limited and the loss of even a small part of this principal generally brings disaster.

It is unfortunately a fact that a very large percentage of women investors are "easy marks" for the promoter and get-rich-quick schemer. They are much more apt to listen to plausible stories of stock market tips and other rainbow opportunities

than is the average practical business man. Many stories could be told of women who have inherited substantial sums of money and have immediately been persuaded by friends, relatives or interested and unprincipled men, to put their entire inheritance into some promotion scheme or some type of security which results in complete and immediate disaster.

I have in mind the case of a woman who some years ago lost her husband whose life was insured for $10,000. This money was absolutely everything she had in the world. The agent who had insured her husband's life immediately offered to cash in the policy for her. This she allowed him to do and when he brought the check to her, he asked, "What are you going to do with this money?" She said that she wanted to invest it to pay the largest return possible.

The agent at once offered to invest the money for her so that she would receive a yield of 6 per cent. This agent, who was undoubtedly a crook, then went to a cheap speculative bond broker and bought from him $10,000 of very speculative street railway bonds, paying 75 cents on the dollar for them. They were 6 per cent. bonds, but the company was not doing well and was almost on the verge of receivership. The bonds were not listed, and had not sold higher than 75 for a long time.

The insurance agent then turned these bonds over

to the widow at 100 cents on the dollar, pocketing for himself $2,500. Before the next coupon fell due, the street railway went into receivers' hands and the bonds defaulted. At once they dropped to 50 cents on the dollar and before the widow could really investigate the matter, the best bid she could get was 40 cents on the dollar. She sold the bonds at this price and thus her small capital was reduced to $4,000.

But this was not the end of the story. A brother-in-law who happened to be a broker's clerk in Wall Street, urged her to let him take this $4,000 and see if he could not double it for her in the stock market. He was a young man of little experience but great assurance. He decided to play the market short on various tips which had come under his notice.

In six months' time he had manipulated the entire $4,000 out of existence and had placed his sister-in-law in debt to the broker to the extent of over a thousand dollars.

This is just one experience among thousands. The woman knew absolutely nothing about investments and took the advice of people who were supposed to know something about the subject. Probably I could fill pages telling of similar instances which have occurred in all parts of the country.

It is necessary to impress very deeply on the minds of people who have no investment knowledge that first of all they should never take the

advice of interested parties. They should never take the advice of a relative or a friend unless that relative or friend happens to be thoroughly expert and informed on investment subjects. The intention of friends is almost always good, but good intentions alone do not make for safety. As many investors have found to their sorrow, friends are often greater amateurs than they are themselves.

Women and dependent people should never forget the fact that nothing more than normal interest return can be secured on any capital unless some risk is taken, and the higher the yield on the capital, the larger the risk. In these days of relatively high investment yields, a larger income return can be secured with safety on investment capital than was the case twenty years ago. In the earlier days it was very difficult for one to invest funds with entire safety and get a yield of much over 5 per cent. Nowadays, however, it is reasonable for investors of this class to try to secure an average of about 6 per cent., but they should not expect to get much more than this without incurring a substantial amount of risk.

And it should further be pointed out that even 6 per cent. cannot safely be secured without broad diversification of funds. One of the greatest mistakes that small investors make who have only a few thousand dollars to invest, is to put all their money into one or two things. For twenty years or

more I have been supervising small investment funds or giving counsel and advice to small investors. Many of these investors have had only a few thousand dollars. Almost invariably they want to put this small sum of money into one or two securities, giving as the reason that it is so much simpler to collect their interest or dividends from one source and it is so much more interesting to see one security rise in value, in which they have a substantial stake, instead of having small sums of money in many different things.

But there is hardly a greater truth to be emphasized than the fact that the smaller the sum possessed, the more important it is that the risk which is inherent in all things be spread over as broad a field as possible and thus minimized to the fullest extent. Only in this way can one feel fully secure and be reasonably certain that there will never be much danger of a serious loss.

As an illustration of how important the principle of broad diversification is, I submit below the experience of two women clients whose affairs I have been familiar with for half a dozen years.

The first client, whose capital sum was about $10,000, agreed to diversify her funds according to a plan we worked out for her. This plan required her to put not more than $500 in any one security. The securities selected were all issues carrying not lower than an *A* rating. They were divided about

evenly between bonds and preferred stocks. The average net yield of the entire twenty issues at the time of purchase was a little over 6 per cent. During the five years following, about half of these securities were changed under our advice and in making the change all but one of these securities were sold either at the price paid or at a premium over this price. Only one of the twenty issues purchased turned out poorly and had to be sold at a loss. The result of this method has been that at the present time this client has all of her principal, with possibly a 10 per cent. increase in valuation, and is still receiving more than 6 per cent. per annum on her original investment. Any one or all of her securities could be sold at any time and bring her back more than her original cash.

The other client who also had about $10,000, refused to adopt the principle of diversification and insisted on having us recommend some good dividend paying stock of strong investment quality which might appreciate in value in the future. The stock I recommended was General Electric, then selling around $150 per share. I urged her, however, to hold this for dividend return and not pay any attention to market prices or think of selling it until I so advised her. The stock after that rose to 180 and, of course, she was greatly excited over her paper profits. She immediately began to feel like a speculator and thought that she was getting rich quick.

She did not sell, however, but the following year when there was a great crash in the stock market, General Electric dropped down to about 125. Panic stricken, she sold her stock in a frightened moment, and, of course, incurred a considerable loss.

Then when times got better and the stock began to rise, she was afraid to buy it, always waiting for a reaction. The reaction never came and, as we know, General Electric kept climbing until by the fall of 1924 it had risen to about 300. In the meantime, this woman investor, who had lost a part of her principal because of her own foolish actions, decided that she would try to make up her loss without any further expert advice. So she went to an interested broker who advised her to buy Pierce Oil Corporation 8 per cent. preferred stock which was then selling at about 90. This was in 1920 or 1921. She put all her capital into Pierce Oil preferred which, at this price, gave her a yield of 9 per cent.

Within one year thereafter Pierce Oil defaulted on its dividend, the stock began to drop in price, and never stopped dropping until it went below 20. Then, frightened again, this woman sold out. As a result of all this, in three or four years' time this woman had lost 80 per cent. of her original capital, as contrasted with the other woman who diversified her investments and still has her capital intact.

More than twenty years ago I expressed the opin-

ion that more money was lost each year by investors than by speculators. What I meant was that the great majority of small investors who thought they were investing their capital, were really speculating with it in the wildest way and were not conscious of the fact that they were doing this. Such was the case of this woman who bought and sold the General Electric stock and then got into the Pierce Oil preferred. She was sure she was an investor, but unconsciously she was a speculator.

I still believe that a tremendous percentage of the money lost in securities in this country every year is lost by people who intend to invest and think they are investing, but who are really speculating. Estimates have been made by the Federal Trade Commission indicating that something like $500,000,000 is lost each year by people in this country who put their money into wild-cat or other promotion schemes. Certainly I believe that a sum fairly comparable to this is lost each year by the many thousands of people who call themselves investors.

It is not to be expected that the average small investor, male or female, should be able to diversify their investment funds with entire safety without special knowledge, experience or expert advice. But even where the best advice is not available, there are many safeguards that can be adopted. Any person of fair intelligence can pick and choose in-

vestments within a restricted range. Let a woman investor with no previous experience examine the daily record of bond quotations on the New York Stock Exchange which are published in the morning newspaper. In this record she will find many bonds selling at prices to show a yield of 4½ per cent. to 5 per cent.

If she buys any of these bonds which show these low yields, she can rest assured that she is not risking her principal to any material extent. If she buys Liberty Bonds she is not risking her principal. But when it comes to the question of getting a larger yield than such bonds show, or diversifying her capital sum into a number of different issues of different characteristics, in different parts of the country, and different parts of the world, it is entirely necessary for her to have special guidance.

As a general investment principle it can be stated that even the completely uninformed investor can, with a little intelligence, buy bonds of high intrinsic value which will yield approximately the market money rate. But this rate may be only 4 per cent. or even less, and in these days such a low percentage is not inducement enough for the small investor to bother with securities at all. Such investors can get a similar rate of interest by simply putting their money into savings banks.

Any added yield beyond the current interest rate, which at the present writing is in the neighborhood

of 4 per cent., is really the compensation secured as a result of the application of intelligent investment knowledge. It is certainly well worth securing this investment knowledge to increase one's assured income from 4 per cent. to 6 per cent. But no small investor, male or female, has the right to expect a yield of 6 per cent. on their capital without risk of principal, unless they already possess expert investment knowledge or use means for getting the benefit of it.

Chapter XVIII

INVESTMENT POLICIES FOR THE MASSES

ONLY within recent years has it been possible to give serious consideration to investment policies for the masses of people of all grades of income and in all walks of life in this country. Prior to the World War about the only sane advice that could be given to the average man in the street with no particular amount of investment capital but with a little saving ability, was to advise him to put his savings in the savings bank and get the 4 per cent. interest which most banks of this character pay. The savings banks were invented for the masses and still operate for the masses. They are a wonderful institution in a country like the United States and probably always will continue to be important. Savings bank deposits have continued to grow in this country for many, many years, and in the Eastern states, at least, are nowadays larger than ever.

But since the days of the flotation of the great Liberty loans and the great increase in production and growth in general wealth in this country, people of all degrees of income and in all walks of life have tended to become direct investors in securities in

ever increasing numbers. The typical man or woman who used to put $100 or $200 a year in a savings bank is now more apt to consider direct investing in securities of some type than was the case in former days. These people were to some extent educated to the idea of holding bonds and cutting coupons during the war period and immediately thereafter. This awakening interest in the investment markets has, however, been further developed by events of a purely modern character which have come into existence in recent years. One of these modern developments has been the growth of a nation-wide movement among corporations to sell their securities directly to employees and to consumers of their products.

The greatest development along this line has taken place in the public utility field. Probably ten years ago there were but a few cases in this country where any substantial public utility corporation had made any attempt to interest its own customers in its securities, and certainly there were few industrial corporations which had offered opportunities to their own employees to become stock or bondholders. The outstanding exception in this country prior to the war was that of the United States Steel Corporation. This company began, more than twenty years ago, to each year offer its employees common stock on some installment plan at a considerable discount from the prevailing

market price. In the earlier years this plan did not work very well simply because the Steel Corporation went through a period of relatively hard times and paid few or no dividends for some years. But with the revival in their affairs, which began after the panic of 1907, the common stock became increasingly valuable and more and more of the Steel Corporation employees began to become substantial owners.

At this writing it is roughly estimated by the best authorities that there are probably in this country more than a million employees of substantial corporations who have become moderate stock holders in the businesses for which they are working; and the tendency is increasing every day. Very few of the large public utility enterprises of the country nowadays fail to invite their employees in on a basis of partial or full ownership of securities, and during the next ten years it seems certain that a high percentage of the capitalization of all the big corporate enterprises of the country will be owned in small units by millions of employees.

Another development has been along the line of customer ownership, as mentioned above. This customer ownership growth has been mainly among public utility enterprises. It promises to increase to far greater proportions as time goes on, and even the highest grade utilities with the largest capital and best credit are turning more and more to their

own consumers for added capital. This growth has been especially marked in cases like that of the American Telephone & Telegraph Company, the Consolidated Gas Company of New York, the Pacific Gas & Electric Company, the Southern California Edison Company, the Philadelphia Rapid Transit Company, and others of this type. As a consequence of this tendency, millions of people in this country who had not the slightest conception ten years ago of what a security investment was, are now becoming actual investors.

This development has been furthered by the policy adopted in recent years by corporations and by governments, of issuing bonds in small denominations. Prior to the war very few American corporations ever issued bonds in smaller denominations than $1000. Nowadays a high percentage of the bond issues which are offered in the New York market are issued not only in $1000 denominations, but also in $500 denominations and many in $100 denominations. Nearly all of the foreign dollar loans which have been sold in this country since the war are issued in small as well as large denominations.

Thus, with this broad development in the investment markets, fields have been opened up which never before existed, for the average man with no capital whatever. Nowadays almost any one can become an investor. A man can start with a $10 bill.

He can buy a $100 bond or a $100 share of stock on the installment plan by paying $10 down and $10 a month. He can thus begin to accumulate capital on a very low basis and if he is systematic and careful in the reinvestment of his interest or dividends, he can build up, in the course of years, a substantial reserve without feeling any real strain whatever.

It is often argued by these small investors that to try to diversify such small sums or to be satisfied with an investment which shows only 5 per cent. or 6 per cent. per annum, is not worth while and, therefore, the tendency of this class of people is unusually pronounced in favor of taking a chance in a speculative proposition. This is one reason why the get-rich-quick promoter finds this field very lucrative. It seems probable that of the enormous sums of money lost every year through wild-cat security buying, a large amount comes from these little investors. It is so easy for a man to be talked into risking a hundred dollars on an oil stock or some other hole in the ground, with the idea that he will shortly make thousands. Consequently, investment education in this field is probably more important than in any other.

These many thousands of people who are what are known as " employee investors " and " consumer investors," need guidance and education fully as much as do larger investors. A man must not assume that because some gas company is offering to

sell him a share of common stock on an installment plan, that he is necessarily getting a high grade investment. He may be getting a more or less speculative piece of paper. And the employee who takes stock from his employer ought to know something about the investment value of that stock before he consents to put his hard-earned savings into it.

Of course, the wisely managed corporation will not sell purely speculative or worthless securities to its own employees or to its own customers. To do this would be shortsighted and would do the management more harm in the long run than the effort would be worth. But managements of corporations, as experience has shown, are not always wise nor is their judgment always of the best. They make mistakes of judgment and other mistakes just as everybody does. To invest money on pure faith is always a speculation. Money should never be invested except on a basis of proven facts.

The kind of education that the very small investor needs is the same kind of education that the large investor needs. He needs expert knowledge of the thing he is investing in. Too often he thinks a thing is cheap because its price is low. He is like the woman who bought a box of cigars for her husband at Christmas. The husband was accustomed to paying $10 a box for his favorite brand. His wife went into a cigar store and discovered a box of

cigars just as large as those her husband smoked and to her eyes just as good looking, and they were only a dollar a box. Naturally when she presented these cigars to him she told him how clever she had been in buying them at a great bargain, having paid only one-tenth the price that he had been foolish enough to pay.

There are investment bonds, as well as stocks, which could be classed as being made of the same kind of sweepings as these one-dollar cigars were made of. I know of an instance where a small investor a few years ago noticed that Interborough-Metropolitan 4½ per cent. bonds were selling on the Stock Exchange at 6. He figured that he could get about $1700 worth of bonds for about $100 in cash. He bought the bonds which on their face were valued at $1700 and paid about $100 for them. He thought he had a bargain but it was not long before he realized that he had paid a pretty high price for a whole lot of wall paper.

In these days, with the very low denominations at which bonds of many types are issued, and with the low valuations of many no par value stocks of good quality, even the smallest investor can start a systematic savings program with wide investment diversification. Suppose a person expects to save only two or three hundred dollars a year. It is possible for that person to invest this small sum in half a dozen or more different enterprises. If, as is

usually the case, he is buying securities on the installment plan, he can easily buy a number of issues with a few dollars a week. It may take him two or three years to pay in full for his investments, but it is much better for him to have several types of issues even in very small amount, rather than to put all his funds into one issue.

In recent years there has begun to be developed in this country what are known as "Investment Trusts." These Investment Trusts are devised primarily for the small investor. This system of investing small sums through Investment Trusts has been developed to a large degree in Europe during the past twenty-five or thirty years. In England alone there are hundreds of Investment Trusts, and the movement has expanded into Holland, Belgium, France, and on the continent generally.

Where an Investment Trust is properly controlled and well protected, it offers a genuine opportunity for a small investor to diversify his capital. But there are several types of these Trusts. The safest type, without any question, is that where specific collateral is deposited with a trust company back of the Trust Certificates or other securities issued and sold to the investor. When this specific collateral, which cannot be changed without liquidating the Trust, is placed behind the certificates which are issued, there can be no question as to the character of the security which the investor holds. Broad

diversification is the main feature of value back of this scheme. It gives the investor an opportunity to diversify his capital without any expert knowledge or experience on his own part, and if the securities deposited are of the proper quality, he has little to fear in the way of loss.

Naturally, however, the yield on an Investment Trust security is not likely to be quite so high as might be the case should the investor select his securities directly and do it with the best intelligence and best judgment. But the average small investor of this type cannot use the best intelligence always, and usually lacks any real experience whatever.

It seems probable that this Investment Trust movement, which is now under way in this country, will grow rapidly during the coming years. It should be encouraged where it is developed by proper and safe methods. It offers a new opportunity for the small investor to place his capital at work in a strongly protected way and with an assured yield often well above the market money rate.

What has been written in the foregoing should not be interpreted, however, as indicating that the mission of the savings bank in this country is being curtailed. Savings banks are the best fields, without any question, for beginning the accumulation of investment funds. It is always best for the average individual of small resources, who can save systematically, to build up a moderate reserve in the

savings bank. The savings bank, as organized under the laws of most of the states, is so well protected by legal restrictions that there is seldom, if ever, any danger of depositors losing their money or running any real risk whatever. I have always been a strong advocate of savings bank deposits for moderate savings, and it is only when one's savings reach a point where obviously better results can be obtained by directly buying securities, that funds should be drawn out for investment.

I know of many instances where people who have become quite opulent have continued to carry savings bank accounts. One of the customary methods of a great many old-fashioned investors is to systematically make savings bank deposits which give them a yield, ordinarily, of about 4 per cent. Such deposits are accumulated until a balance of $1000 or $2000 is reached, after which a portion of the balance is withdrawn and invested in good bonds. By this method one has always some free cash available for taking advantage of attractive investment opportunities as they come along, and further, always has cash available if needed for an emergency, which might not otherwise be secured without selling securities at a possible sacrifice.

The man who puts money in a savings bank is investing in securities just as truly as is the man who directly buys securities. The savings bank itself buys securities and keeps its deposits at work under

legal restrictions in the investment fields. Savings banks do not operate in states like New York for profit. They are not stock corporations and do not pay dividends to stockholders. Whatever surplus they may have from year to year above expenses and what they pay out in interest, is put in a reserve for the depositors. A healthy savings bank, if it liquidates, will return its entire accumulated surplus to its depositors and thus, in the event of a bank going out of business, a depositor will sometimes find that he actually gets more than the regular rate which is currently paid to him.

Of course, healthy savings banks do not often go out of business, but it is an added element of security for the depositor to have his pro rata interest in the accumulated surplus of the bank.

Chapter XIX

MANAGEMENT OF INVESTMENT FUNDS

A PERMANENT policy for the management of investments in a scientific way becomes more important to both institutions and individual investors as time goes on. The investment fields in this country have become so involved and the influences and cross currents which affect investment values of every type, have so greatly increased in modern times that the handling of substantial investment funds in an intelligent way, to secure the best results, has become a science in itself.

The past practice of haphazard buying of securities whenever they looked attractive to the purchaser is rapidly becoming discredited in this country. Even where investment selections of good quality or character are made, the result is often unsatisfactory because of the untimeliness of purchases. I will, therefore, attempt to present in the following paragraphs a general plan or method of investment management for permanent use on the part of both institutions and individual investors of substantial character. This plan is intended not

for any one period, but for the whole duration of long periods of years.

There are three major principles to be adopted in broad investment management. These three are, first, the rotation of investment holdings in accordance with financial and business conditions; second, the proper diversification of one's holdings, whether bonds or stocks; and, third, the scientific use of ratings and of economic facts in making investment selections.

As an instance of the importance of rotation, it would be suicidal, it seems to me, to sell out high grade short term bonds at the top of a bull movement in securities, and invest in common stocks, but at the bottom of a bear movement in securities, this sort of an exchange in part, at least, might prove highly beneficial. Diversification is the most reliable method for avoiding the penalties of individual mistakes and for obtaining the benefit of the trend in the security market. Bond and stock ratings in turn can very readily be used in connection with the selection and diversification of individual issues.

There are four different types of movements in securities to which the investor should adapt himself in order to be successful. These are, first, what is known in Wall Street as the bull movement; second, the so-called distributing market at the high altitude; third, the so-called bear movement; and, fourth, the so-called accumulating market around

the bottom prices. Expressing the same thought in another way, the security markets go up the mountain side in times of business expansion, go over the top in times of boom or inflation, go down the other side in times of forced liquidation, and gradually swing through the bottom of the valley at the depth of business depressions.

This general swing of the business cycle is directly reflected in security price movements. These movements through the four stages develop, of course, in a more or less irregular fashion. These stages in the general cycle are not sharply defined, and it is often difficult to tell where one ends and the next begins. But the investor who wishes to get the best results must adapt himself and his holdings, so far as possible, to these movements.

The proper method to pursue is this. First, during a bull market, so-called, the aim should be to hold an extra high percentage of those types of bonds, notes and stocks, which naturally rise the most when a period of prosperity is immediately ahead. Second, upon the mountain top of prices, one's method should be to gradually exchange out of all those types of securities whose prices yield easily to liquidation, and into the more stable types whose prices tend to remain unchanged under all conditions. Third, during the downward movement or liquidating period, the aim should be merely protection of capital and nothing else, for in view of the

fact that during a major bear movement bonds decline sometimes from 20 per cent. to 60 per cent. or 70 per cent., even a 3 per cent. yield looks attractive in keeping one's principal intact. Fourth, during a business depression the effort should be to exchange out of the extremely gilt edge, low interest bonds and notes, and into bonds and stocks which will rise strongly during the next upward swing.

This latter period is generally known as an accumulating market and applies not merely to the stock market but to the investment market in a very real way. It is the time of the depth of a business depression following a period of drastic liquidation. At such a time the element of risk has been largely eliminated not only from low grade bonds, but also from most stocks. Therefore, after making sure that a major liquidating period has actually occurred, one is generally safe in taking on liberal purchases of bonds of lower ratings and often reputable investment stocks of many classes. The securities selected should be the ones which have declined the most, being careful, however, to ascertain that they are of good character and are backed by good managements and balance sheets which indicate no danger of receivership. A thorough depression of this kind generally takes most of the risk out of such bonds and stocks and at such times the investor can afford to buy a proportion of even common stocks of good character which at other times

he naturally would not think of touching. For example, a period like that of 1921 was ideal for buying high and medium grade railroad bonds and many sound industrial stocks which were selling far below asset values.

The general purpose during a bull or bear movement should be to continue to hold the fluctuating types of bonds and stocks at least until they go high enough so that the risk in them begins to reappear. While their prices are rising from subnormal to average there is little risk in them. One need not pretend to any expert market knowledge at such times, for as a matter of fact, so-called bull movements in both bonds and stocks are simultaneous and largely coincident with eras of expanding general prosperity. In a distributing market, which is the time when a general business revival reaches its peak, there is always a similar peak in the prices of representative bonds and stocks. Often, both bonds and stocks reach this peak approximately together, but at other times, especially when earnings are growing rapidly, bonds reach the peak months ahead of stocks. At this time one should make a general change into securities of the highest ratings and especially into gilt edge bonds and notes; the proportion of stocks should be greatly reduced, as these, when the next decline occurs, will depreciate much more than the bonds. At this juncture one should have realized a substantial profit on his principal

through the general upward movement in stocks and bonds and should now be willing to gradually change into bonds and notes showing lower yields, with the sole view of increasing the safety of principal.

Throughout the duration of a declining movement in the security markets, these low yield, highly stable securities should be continuously held, since the main purpose now is to avoid shrinkage in the market value of one's principal. It is more important to avoid a 25 per cent. loss than it is to make a 25 per cent. profit. Bear movements in securities, as in business, never occur except as the result of inflation in one form or another. After such inflation has really developed, the investor should not switch out of his high grade short term securities until the anticipated liquidation has occurred and terminated.

It is assumed, of course, that the investor can identify approximately the times to make such changes. This he can do either from a knowledge of the timing or synchronism of his own business with general trade, or else by the use of economic facts. The course of the security markets is determined primarily by the rise and fall of the prosperity of our leading industries. Hence the man who knows the general business situation thereby must know when to make his investment changes. If he desires assistance from economic research, he should employ

experts or specialists who make a study of such matters. The greatest danger, however, to the average investor is to use superficial judgment and to be in haste to act. Large business or economic movements run slowly and there is always plenty of time for the investor to make his changes if he keeps his mind on the subject. In all investment operations carried on, the principle of diversification should be closely adhered to. It is better to have ten $1000 bonds than one $10,000 bond, and also to have one hundred shares each of ten stocks than a thousand shares of one stock. Any security may at any time move contrary to the trend of the markets and of general business, but a well diversified list never moves contrary. Investing, like economics, is no such exact science as to enable any man, however expert, to be sure that a single selection is the best. Furthermore, in this process of diversification a group or assortment of securities should be bought as a whole, and held as a whole, and later sold as a whole. If one makes a practice of selling those securities in which he has a profit, and holding the remainder in the hope of a profit, he usually finds that he has sold out the ones that go up the most, thus forfeiting a large profit, and then when a drastic decline occurs he still is holding the weakest securities which will decline the most violently. In other words, by not going into and out of an assortment as a whole, his instinctive selection so works out

that he disposes of the fine securities and keeps the rotten eggs.

The most simplified method of making selections is to employ Moody's ratings of bonds and stocks. The general principle should be to take on a larger proposition of low rated securities during an accumulating market and to switch into high rated securities exclusively before the end of the distributing market. The lower the rating, the wider are the price swings of a stock or bond, and the higher the rating, the greater, as a rule, is the stability or constancy of price. Furthermore, the investor, after he has determined what percentage of his total funds he will place in securities of different grades, can conveniently make use of the ratings to find out what stocks and bonds belong to each grade respectively. Besides this, among securities of the same class and representing the same industry or the same or similar governments, it is a proper practice to select from those of equal rating the ones which show the better yields.

This discussion is, of course, a bare outline of a great subject. I have not suggested any percentage distribution for one's capital since this varies with the character of the institution or investor and also with the financial situation. Manifestly, the percentage distribution should be very different at the top of a bull movement from what it should be at the bottom of a bear movement. Nor have I dis-

cussed the time allowed for completing a switch in either direction. As a rule, both distributing and accumulating markets show a minimum duration of about four months, while not infrequently they last six to eight months. This means that one may take plenty of time around the ends of both bull and bear movements without losing his opportunity. He will have time to deliberately examine business statistics, and economic records, and corporation balance sheets, and all other information, because there is no hurry.

Nor have I gone into the relative merits of long and short term securities in this article. The general rule, of course, is that the longer the term, the greater the response to the changes in the price of capital, and, therefore, the wider price fluctuations, and vice versa. During the first stage of a decline in bonds from a high peak, before stocks become acutely weak, the medium grade short term notes hold better than the highest grade because there is less competition between them and commercial paper. But after stocks become acutely weak, the highest grade short term notes hold better than the long term bonds.

Chapter XX

EXAMPLES OF SUCCESSFUL INVESTMENT POLICIES

ON the following pages I am going to present four concrete examples of successful policies followed by four different types of investors during the past fifteen years. These are all instances with which I am personally familiar and in each case I followed closely the program of each investor.

The first example is that of a professional man located in one of the Eastern states who in the year 1910 approached me for investment advice. He was a single man in middle life who had a mother and several sisters dependent on him for support. His income from his profession was not sufficient to cover the necessary living expenses of this family, but he fortunately inherited about $30,000 in real estate and other property a short time before I met him and it was his desire to so invest this capital that he could be assured of an additional permanent revenue of at least $2000 per year. He did not want to speculate but he was extremely desirous of making such investments that there would be a possibility, during the following years, of an increase in

his capital and consequently an enlargement in the total income.

The year 1910 was one of reaction in the security markets. Before the year had closed, prices of even good investment stocks had undergone a long decline and it was an excellent time for an investor to buy sound dividend-paying stocks, especially of the preferred variety. Bonds as a class were at that time selling relatively high and it seemed unwise to purchase long term issues at the prices then prevailing. It was, however, an excellent time to buy relatively short term bonds of undoubted security which were selling at substantial discounts below their par values.

This investor decided to divide his capital of $30,000 into three parts; one-third to be placed in railroad securities, one-third in public utilities, and one-third in industrials. The railroad issues which he bought were confined to bonds, for the very good reason that at that time the political situation was a menace to the railroads of the country and most of the roads were suffering severely because of rising operating costs and inability to increase freight rates. The Interstate Commerce Commission had taken a very arbitrary stand against the raising of rates and Congress was at that time permeated with anti-railroad legislation.

At that same time, good underlying railroad bonds of relatively short maturity looked extremely at-

tractive. This man bought such issues as Colorado & Southern 4s, Michigan Central 4s and St. Louis, Iron Mountain & Southern 4s, all selling far below par and all maturing within twenty years or less.

In the public utility field, his selections were confined primarily to electric light and power bonds or stocks. Even then, the rising operating costs of street railways had begun to undermine the credit of the latter, while the inevitable growth in the uses of electric light and power foreshadowed increased prosperity even in the face of political disturbances. In the industrial field, this investor avoided the stocks of basic industries, such as steel, copper, etc., and gave preference at that time to the stocks of trading or distributing concerns, such as Woolworth, United Cigar Stores, Sears, Roebuck & Company and United Fruit Company.

In all, the $30,000 was invested in about twenty-five distinct issues and the average yield at the start was about $2300 per annum. This investor, however, recognized the importance of watching his investments, keeping track of trade and financial conditions, and taking advantage of new developments from time to time. He therefore quite systematically checked up his list in the light of price changes and new conditions, and by the opening of the war in 1914 had almost completely changed his list. In doing this he had almost invariably taken profits, with only a very occasional moderate loss. When the

war opened in 1914 his list had been gradually changed until at least two-thirds of his capital was invested in certain types of industrial securities, all of which were in a position to be benefitted by war conditions. Before the beginning of 1915 he had disposed of nearly every public utility and railroad security and had a certain amount of free cash which he invested in basic American industries, such as steel, copper, leather, rubber, etc.

During the following year all of these industrial activities went into a period of vast prosperity and their stock issues rose to great heights. He therefore found that by the end of 1916 he was in a position to sell out most of his investments at prices which increased his total capital to over $50,000. Being a man who studied the fundamental influences, he at once recognized that if the United States went into war in 1917, a very serious change would take place in the trend of American security prices. Consequently, in January, 1917, he sold nearly everything he had. He did not buy any new issues during 1917 but put most of his capital into Liberty bonds, keeping his capital so invested until after the end of the war. Thus, the years 1917 and 1918 greatly reduced his current income, but his capital was intact and in a liquid form and could be turned into cash at a moment's notice.

Early in 1919 this investor made up an entirely new list and invested his $50,000 or more in possibly

thirty different securities, mostly industrial stocks which were dividend payers and rated high. He did not buy any so-called speculative issues whatever. As is well known, everything went up unreasonably high before the end of 1919 and during that movement this investor was carried along with the current, and at the opening of 1920 had increased his capital to about $70,000. He then had courage enough and sanity enough to sell everything he had and leave his money in the bank for a time.

In the Autumn of 1920 he began to reinvest. He confined his selections this time mainly to high grade bonds, although he did buy small amounts of such stocks as Western Union, Atlantic Coast Line, Illinois Central, and American Telephone and Telegraph. After this he made no changes in his list until 1923. Then he sold some of his high grade railroad bonds, buying some General Electric at about 160, and one or two public utility common stocks, like Pacific Gas & Electric and Carolina Power & Light.

At the opening of 1925 this investor's capital amounted to approximately $100,000. His approximate income equalled about $6,000 a year. During this entire period of nearly fifteen years, he had always consumed his interest and dividends and had simply reinvested actual profits which had been made by changes in prices. He never bought a security on margin and never borrowed any money.

The lesson to be drawn from this example is that an investor can, without running speculative risk, substantially increase his principal over a long series of years, provided he has the capacity to intelligently interpret fundamental trends and changes and has the courage of his convictions.

The second example is that of a retired business man who, in the year 1912, sold out a small manufacturing plant, realizing about $100,000. He was a man under fifty years of age who had worked hard all his life, but whose health had been undermined and who wished to take a long rest and live on his income. He was that peculiar type of man who wished to be not bothered with details or even take the trouble of watching his investments or cutting coupons. He therefore declined to invest in bonds, but insisted that he would confine all his selections to dividend-paying stocks, and he wanted to get an average of 6 per cent. on his money.

The principle of diversification did not at first appeal to this man. He wanted to buy one security with all his capital and let it go at that. He was, however, willing to take the time to find one undeniably good and entirely secure issue, even though it took a year to make the selection and even though he might have to wait even longer to get his issue at the right price.

The year 1912 was the time that the great Standard Oil dissolution was carried through. The stocks

of the several new Standard Oil Companies shortly thereafter came on the market and began to be actively traded in. This man spent a full year studying the oil industry and the underlying facts regarding the Standard Oil interests. At the end of that time he had thoroughly convinced himself that the ideal investment for him to make was to buy Standard Oil of New Jersey, then selling around $300 per share. Consequently, he put his entire $100,000 into this stock.

After that, this man evidently forgot that he had any investment. He drew his dividends regularly and lived on them. He travelled all over the world and never had a worry. All during the period of the war he paid no attention to the security markets and gave no thought to selling out his Standard Oil. But undoubtedly he was, during all this period, keeping closely in touch with developments in the oil industry and business developments in general.

Finally, a few years after the war he decided to sell his Standard Oil. By that time it was being quoted at an equivalent, for the old stock, of about $800 per share, and with various extra dividends he had added further amounts to his capital. He was now a rich man. For some time thereafter, he kept his capital invested in Liberty Bonds and Treasury Certificates, but during this period he was making a personal and conscientious study of the General Electric Company. Some time in 1922,

therefore, he put his entire fortune into General Electric stock, buying it at an average price of about 150. So far as I know, he still has his entire fortune in General Electric and thus has more than doubled his capital again.

There are but few investors who can achieve success on this simple plan. This man, however, was not only unusually sound in judgment, but he was the type of thorough student which one does not often meet with in the investment atmosphere. He recognized, rightly enough, that the investment of his fortune was one of the most important programs of his life, and being a big man, mentally and by nature, he refused to involve himself in details but concentrated steadily to find and take advantage of one or two big opportunities.

A third example which I wish to present in some detail is that of a widow who was, about 1915, left by her husband with about $5000 and two small children. She was obliged to go into business life to support herself and children, but was wise enough not to allow her relatives or friends to induce her to invest her small capital in get-rich-quick schemes or doubtful ventures. On sound advice she placed her money in Anglo-French 5s which were issued during that year and at first sold in the neighborhood of 95. She knew nothing about investments but trusted entirely to the advice which I attempted to give her. She held the Anglo-French 5s through

until 1919 when they rose to a fraction above par. Naturally she was anxious to get as large an income yield as possible, and consequently the foreign dollar bonds, which were beginning to be floated in this country after the close of the war, were of decided interest to her. It was difficult to keep her from taking chances in speculative issues, but she finally, in 1920, put her capital into Swiss Government 8 per cent. bonds which at that time were selling around par. These bonds were unquestionably just as good as Anglo-French 5s, as subsequent events have proven. She was urged to, and did, keep these Swiss Government 8s until 1922 when she sold them at 120. This gave her quite a little addition to her capital, and I therefore advised her to select two investments instead of one. Naturally, she wanted both security and liberal income, and as it happened, along in 1923, there had been a very radical reaction in the prices of many foreign issues and consequently very attractive opportunities for reinvestments were available. The new bonds she bought were Kingdom of Belgium 7½s, slightly below par, and Kingdom of Denmark 6s, then selling at about 93.

At last reports this investor still held these two issues and, so far as I know, has no plans for immediate change. By the summer of 1925 the Belgian issue, which will ultimately be paid off at 115, was selling around 108 and the Denmark issue, which falls due in 1942, was selling around 104.

This is an illustration of how a woman investor of small capital, who will seek expert advice and act on it, and who succumbs to no temptation to try to double her money, may do very well indeed with entire safety. The yield which this woman is receiving is far above the average yield which the ordinary conservative investor usually gets, and there has been, in addition, an increase, up to date, of about 30 per cent. in her principal sum.

Another example which I want to present is that of an investor whose chief characteristic was the ability to use unlimited patience in investing his money. The great weakness with most investors is that, when they have capital to invest, they insist on immediately putting it into some form of security and they think if it is not set to work at once, they are losing valuable time and will let great opportunities slip by. This man, however, was more far-seeing and was able to act with the deliberateness that is sometimes absolutely necessary if one is to finally do the right thing.

In the early Spring of 1920 this particular investor approached me, explaining that he had $50,000 which he wished to invest. Prior to this time he had never been an investor and this money had come to him as a result of the final liquidation of some war contracts in which he had been interested during the war days.

As it was all the money he had in the world, he

did not want to take chances. Many friends and some bankers had recommended to him many types of securities and many methods for investment. In all cases they had urged him to invest at once, and no one had particularly suggested to him that a waiting policy at that time might be very wise.

The first thing I said to him was to keep his money on deposit, getting the best interest return possible, and forget it for a while. I said that he might have to leave it in this condition for six months and perhaps even for a year. At first he thought this was pretty poor service to render, but I told him that if he would come back to see me six months to a year later, he would certainly then tell me that this advice had been absolutely priceless to him and that he need not pay me anything in the shape of a fee for this advice unless he was then satisfied that it had been sound.

This man did not get in touch with me again until the summer of 1921. He then came into my office and said with a smile that he had followed my advice. He had been getting something like 4 per cent. on time deposits in banks, which, of course, was below the current rate, but had satisfied him. He had been watching the security markets all this period and had seen the enormous declines which took place during 1920 and most of 1921 among both high grade and speculative issues. He was now ready to receive some further advice.

The markets at that time were practically at the bottom. Liberty Bonds were selling around 85 to 87. All high grade bonds were selling at ridiculously low prices. The long period of deflation was nearing its end and typical stocks had not yet begun to recover to any substantial extent. It was, therefore, an ideal time to invest money intelligently, and this man took advantage of it. His capital was carefully diversified among a dozen different issues — some bonds and some dividend-paying stocks. He bought, for example, small amounts of General Electric, Atlantic Coast Line, American Car & Foundry, American Can preferred, and also some foreign bonds, such as Swiss 8s, Denmark 8s, United Kingdom of Great Britain 5½s, and Belgian 8s, and the balance was distributed among American railroad bonds and public utility bonds.

Since that time this investor has occasionally taken profits and made changes which have been wise. He has never made an important mistake and, so far as I know, has never found it necessary to take a loss. At the present writing his capital has been substantially increased and he is receiving a liberal income.

The moral to be drawn from this investor's experience is not merely that he used sound judgment in selection or employed expert service to guide him during his investing days. It is rather that he showed, in an unusual sense, the ability to

resist the temptation of investing his money at the wrong time. There are only a few investors who seem to have the patience and courage to follow this policy. They appear to think that if one waits before investing, worth-while opportunities will surely slip by and that they will have lost their chance to get the best out of their capital.

I often say to people who are impatient regarding investment matters and who occasionally see, with regret, good opportunities slip by, that the investment market will always be with us and that new opportunities for wise investment come along just as fast as old opportunities disappear.

Chapter XXI

REVIEW AND CONCLUSION

FOR those who have carefully read and digested all of the twenty foregoing chapters, a general review or summing up of the subject may not be necessary. But it is almost invariably the case that those who read books of this kind do not give serious attention to all the phases of the subject, and the things remembered distinctly are usually only those matters which are of paramount interest to the reader at the time. This series of chapters has been written not for one particular type of investor, but for the general investing public. Unquestionably certain chapters will prove to be more worth while and more valuable to particular persons than others. But, nevertheless, a general perspective of the whole subject should be worth while to all.

In approaching the investment problem every investor, large or small, should realize the importance of building up some sort of a perspective. His first effort, therefore, should be to achieve a clear understanding of what the investment of money in securities really signifies. When one buys a bond or stock, all he gets in exchange for his money is a

piece of paper on which certain things are printed or engraved. To many an investor this piece of paper appears to be the only thing that he is buying. He does not think beyond this, and when he locks up his bonds in the safe deposit box, it merely seems to him that there his money lies. But this is far from the truth. A piece of paper in the safe deposit box is nothing but a symbol. It merely shows just where his money has probably gone to, but it does not indicate how the money is being used or in what way it is being set to work. He goes every six months to cut his coupon; he deposits this coupon in his bank. This coupon appears to be something which has suddenly taken on value and life on the payment date. Just how this coupon comes to have a specified value on a certain date does not usually occur to him. He thinks, naturally, that if his bond were burned up or he mislaid it, he would no longer have any property. But this would not be true at all, even though he might have some difficulty in proving his ownership to his property.

When a man invests, we will say, a sum like $1000 in a bond, the actual money that he pays for the bond of course goes to the seller of the bond. But this seller did not create the bond. He bought it from somebody else. If he is the dealer who originally floated the issue, he bought it from the corporation. The corporation created it by putting a mortgage on its property. The motive for mort-

gaging the property may have been that the corporation needed working capital. Thus, the money received by the corporation for the bond is used in one form or another in the business. It may be used for payrolls, for purchases of supplies, for the payment of debts, for new construction, or for a thousand other things. This particular money may be lost, dissipated or stolen. It may simply be used to cover up some earlier loss, or, on the other hand, it may be set to work in some way which will help in producing new profits.

And so it is all along the line. A man buys a railroad stock. Originally the railroad may or may not have received actual money for this stock. The investor may be buying something which the railroad has issued without receiving any current cash equivalent, and yet the stock may be a high grade investment and it may be paying a liberal dividend. But it usually does not occur to the investor that when he buys a railroad stock he may be paying his money into the hands of some people who never pass it on and never have to pass it on in any way to the railroad.

Another illustration to be considered is that of government bonds. What do governments do with the money that is received by them for the bonds which they issue? When a man buys an Argentine Government bond, he instinctively assumes that his money, in some way or other, goes to Argentina and

will be permanently lodged there until it is returned to him at the maturity of the bond.

Now it may be that even when a man buys a brand-new Argentine issue, his particular money never gets into Argentina. It may be used for a variety of things. Perhaps it helps to pay off a debt with some foreign country. Perhaps it is used to stabilize exchange. Perhaps it is used to liquidate interest due on other loans, or perhaps it is used to pay for some expenditure made long months or years ago.

When one explains these processes to the average man who has no knowledge of financial, municipal or banking activities, he is apt to jump to the conclusion that somebody, somewhere, somehow, is misusing his capital, and this feeling conveys the impression that it is a dangerous thing to invest money unless one is in a position at all times to watch and see just what is being done with it. It is the same feeling that the old farmer had who loaned money to his neighbor in preference to loaning money on better security to some one a thousand miles away. He felt that he could watch his neighbor daily and thus see what was being done with his money. The man 1000 miles away could never be directly watched by him.

The thought I am trying to bring out by this discussion is that it is extremely important for every type of investor to acquire some knowledge, even if

of a most elementary kind, of investment processes and of the general methods whereby corporate capital is put to work. This knowledge, even in the most elementary way, cannot be acquired without one's attempting to get some vision of modern corporate activities as a whole. Consequently, in the earlier chapters of this book I have elaborated to a considerable extent on the modern investment field and have tried to emphasize the various phases through which corporate activities have gone during the last generation or two. For any intelligent investment policy cannot be followed unless one is able to acquire a broad vision of corporate and governmental activities as a whole. If the investor is ignorant of the whole problem and specializes merely on certain phases of it, it is practically impossible for him to exercise mature judgment or to weigh all the arguments for and against investing money in particular things and at particular times.

The first chapters in the book are therefore given to this general view of investment problems. I have followed this up with a more or less extended discussion of diversification of investment capital, and, as the reader knows, have devoted a series of chapters to the problems of investing in different classes of issues in the several fields of corporate activities and in the various geographical sections of the world.

But probably the most important phase of the whole investment subject for the individual investor

to give attention to, is that of investment cycles, so-called. Enough has been said in the foregoing chapters to bring out strongly to the thoughtful man the fact that successful investing involves a careful and continuous study of fundamental trends and changes in economic and financial conditions. It cannot be too often reiterated that there is a time to buy and a time not to buy; that there is a time to sell and a time not to sell. If serious attention is not given to this side of the investment problem, then real investment success in these days is practically impossible.

Of course, there are certain types of investors who pretend not to be interested in changing conditions in the money market, in changing prices in securities issues, and assert that all they want is absolute security of principal with the best income return possible. But such people overlook the fact that even the most genuine values are affected by changes in economic and social conditions. What may be almost 100 per cent. secure in one decade or generation may not be anything like 100 per cent. secure in the next decade. Profound changes are constantly taking place in civilized society, and over a reasonably long period of time the face of civilization undergoes very radical readjustments. The period is so short since the great development of the capitalistic and credit systems in civilized society, that many people find it hard to get the proper perspective. It is thought by

so many that property values, which are recognized as of the strongest type to-day, will always be property values of this type, and we often hear men say that such and such a piece of property has maintained its value for a thousand years or more. Investigation, however, demonstrates that this is entirely untrue. One needs to go back only about 150 years to find that property values of certain types which then existed and were regarded as of the highest possible rate in England, have since become practically worthless. On the other hand, many processes which fifty or one hundred years ago were looked upon as practically valueless or certainly highly speculative, have come, in these days, to be recognized as the highest type of secure property values.

Building up the broad, fundamental background, which involves a general knowledge of economic trends and commercial activities, is the first real job for any one who wishes to become an intelligent investor. This general knowledge and perspective is the foundation from which he can approach the various details of the problem. If he has this fundamental knowledge, it is then comparatively simple for him to take up the various questions of policy and problems of diversification which are important for every type of man who has capital to put to work outside of his own direct business activities.

In some of the later chapters in the foregoing

series I have tried to emphasize the importance of what is called "constructive investing." Constructive investing, in its broadest sense, is a process which takes into consideration not only the specific questions of quality in particular investments, but links to this the necessary knowledge regarding investment cycles and investment trends. If one can tie together these phases of the investment problem, giving equal thought and intelligence to questions of selection, as well as to the many factors in the fundamental trend, he then has an opportunity to succeed greatly.

The several examples submitted in the last chapter of successful investment policies, point out the methods of application which have been employed by several different types of people. Each person, of course, has his own individual problem. There is no hard-and-fast rule for all investors. Everyone must necessarily make his own exceptions according to his needs. There is a large class of people who are willing to undergo risks for the sake of possible added income, and such people naturally look for substantial compensation for taking these risks. Others, however, cannot afford to take risks. Their principle should be, as I have emphasized again and again, to think first and always wholly of the security of their principal and to be satisfied with a normal income return. But thinking first of your principal does not, as I have pointed out, consist merely in

putting it into something which at the moment appears good. It involves, just as much as does the question of income, the problem of occasionally making changes in the character of the investment in order to conform with changing economic conditions.